Review Essay

The Corporate Law Paradox: The Case For Restructuring Corporate Law

The Economic Structure of Corporate Law. By Frank H. Easterbrook* & Daniel R. Fischel.** *Cambridge: Harvard University Press*, 1991. Pp. viii, 370. $39.95.

Robert M. Daines† and Jon D. Hanson††

CONTENTS

INTRODUCTION 578

I. HERESY IN HYDE PARK: EASTERBROOK AND FISCHEL V. THE MARKET 581
  A. *The Paradox: Things Fall Apart; The Center Cannot Hold* 584
    1. *Articles of Incorporation* 585
    2. *State Law* 587
  B. *The Paradox Unresolved* 589
    1. *Regulatory Interference with Contracts* 590

---

* Judge, United States Court of Appeals for the Seventh Circuit.

** Lee and Brena Freeman Professor of Law, University of Chicago.

† B.A., B.S. 1989, Brigham Young University; J.D. 1992, Yale Law School.

†† Assistant Professor, Harvard Law School. B.A. 1986, Rice University; J.D. 1990, Yale Law School.

Helpful comments were provided by Lucian Bebchuk, Robert Clark, Steven Croley, Robert Ellickson, Stephen Fraidin, Howell Jackson, Reinier Kraakman, Larry Kramer, Kyle Logue, and participants at the Harvard Law School Faculty Workshop. We are grateful also to the Harvard Law School Summer Research Program for financial support and to Yale Law School for making the initial stages of our research possible. Finally, we want to give very special thanks to Ruth Ann and McKay Daines and Kathleen and Emily Hanson.

2. *Ex Ante Contracting Costs* 591
3. *Ex Post Contracting Costs* 593
4. *The Efficiency of Resistance?* 596
C. *Conclusion* 597

II. PROPERTY RULES, LIABILITY RULES, AND UNAVAILABILITY: PROTECTING SHAREHOLDERS' RIGHT TO TRANSFER SHARES 600
A. *Property Rule Protection* 600
B. *No Protection or "Unavailability"* 602
C. *The Case for Liability Rule Protection* 603
1. *The Basic Model* 606
2. *Optimizing Search* 609
3. *The Implications of Private Information on Publicly Traded Stock* . . 610
4. *Are Capital Markets Fundamentally Efficient?* 613
5. *Lawmaking in Uncertainty* 617
6. *The Emergence of a Market in Resistance Bonding* 621
a. *The Passivity Pill: Taking Rights Seriously* 622
b. *Why It Would Work* 625
7. *The Law as a Laboratory* 631

CONCLUSION: TWO CHEERS FOR *CORPORATE LAW* 634

> [T]he test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function.
>
> F. Scott Fitzgerald[1]

INTRODUCTION

The Economic Structure of Corporate Law is truly first-rate: though it contains two opposed ideas, it nevertheless explains much of corporate law. Capping off a decade of enormous productivity, Judge Easterbrook and Professor Fischel have written what is arguably the most important—and most readable—corporate law book ever. It is sure to be a classic. Although Easterbrook and Fischel modestly call theirs "an exploratory treatment, a survey,"[2] future corporate law scholarship will likely refine, rather than supplant, the book's central theses. These theses are certain to change the way corporate law is taught,

1. F. SCOTT FITZGERALD, *The Crack-Up*, *in* THE CRACK-UP 69 (Edmund Wilson ed., 1956).
2. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW viii (1991) [hereinafter CORPORATE LAW].

understood, and possibly even made. As we will discuss later, however, the authors may find the book's impact a mixed blessing.[3]

The book is written in a brisk, easy-to-read style, effective for conveying its broad theses. Rather than rely on dry analytics, Easterbrook and Fischel pack their chapters with uncommon common sense and a refreshingly vital vocabulary: investors "fork over" money,[4] law firms "peddle" contracts and "dicker" over terms,[5] fiduciary duties "trump" contracts,[6] firms strike "mother lodes,"[7] and unfaithful managers are "given a quick boot."[8] Much like Adam Smith's *The Wealth of Nations*, their general analysis is conveyed in realistic descriptions of motivations and incentives[9] and in informal narratives that are both easy to read and memorable.[10] This approach, though often more enlightening than formal doctrinal discussions of legal rules, is at times inconsistent with the detailed analysis required for some of the individual debates: the book's broad-brush strokes occasionally blur critical assumptions. In addition, eager to push home their points, Easterbrook and Fischel sometimes assume too much familiarity with legal doctrines, occasionally making the book difficult for the beginner.[11] On the whole, however, theirs is a happy blend of ease and explanation.

The book's building blocks are previously published articles on everything from limited liability to optimal damages in securities litigation. Perhaps because the book *is* a collection of independently written articles, it is occasionally internally inconsistent.[12] Nevertheless, the collection has many advan-

3. *See infra* text accompanying note 266.

4. CORPORATE LAW, *supra* note 2, at 4.

5. *Id.* at 35.

6. *Id.* at 93.

7. *Id.* at 254.

8. *Id.* at 76; *see also id.* at 98 (managers' bad decision is a "howler"); *id.* at 157 (courts value stocks by using a "bucket full of methods"). *But see id.* at 92 (managers' one-time "defalcations").

9. *See, e.g.*, ADAM SMITH, THE WEALTH OF NATIONS 26-27 (R. H. Campbell et al., eds., Clarendon Press 1976) (1776) ("It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.").

10. An example is the book's almost comically literal suggestion that one's approach to corporate law depends on one's idea of a corporation's birth.

> You are likely to be driven to a regulatory view of corporations if you assume that corporations are *born* with a complement of managers, employees, and investors. . . . But corporations do not arise by *spontaneous generation*. . . . They must attract customers and investors by promising and delivering what those people value. Corporations that do not do so will not *survive*. When people observe that firms are very large in relation to *single investors*, they observe the product of success in satisfying investors and customers.

Id. at 4 (emphasis added).

11. This difficulty no doubt results from the fact that the book is built around their articles, which engaged in (and began) sophisticated debates with knowledgeable scholars. For this reason, the book will not supplant Dean Clark's book as the law student's best in-depth introduction to corporate law. *See* ROBERT C. CLARK, CORPORATE LAW (1986). Clark's work forgives a lack of legal knowledge while still covering all the important doctrines and theories. It is self-consciously tailored to an audience of "future lawyers." *Id.* at xiii. The intended audience of Easterbrook and Fischel's contributions is less clear.

12. *Compare* CORPORATE LAW, *supra* note 2, at 169 (arguing that contracts allowing loyal auctions would be difficult or impossible to write) *with id.* at 205 (arguing that it is "easy to [write contracts] to facilitate auctions while tying managers' hands").

tages—chiefly that their central thesis gains momentum as Easterbrook and Fischel move through area after area of corporate law, revealing the logic of agency cost reduction. The collection proves that in academic tracts, as well as in corporations and contracts, there are synergy gains from valuable combinations.

Although the book would be useful if it only collected the two authors' ground-breaking work, it is much more than a collection of their "Greatest Hits." Many chapters are completely new or, as they put it, "written from scratch."[13] For instance, they add new analysis to topics such as the fiduciary principle, the business judgment rule, the appraisal remedy, state takeover statutes, and the prohibition of trading on inside information.[14] The book also differs slightly from their earlier articles, showing increased attention to the variety of corporate forms and purposes. For instance, they here explicitly acknowledge (and even endorse) the fact that profit may not be the primary goal of some corporations.[15] Moreover, even familiar arguments have been reworked. As they put it, "all portions of the book (including those based on articles) have been substantially revised and updated."[16] In short, we are presented with both new and newly revised material which purports to comprehend Easterbrook and Fischel's previous work.

Part I of this Essay first describes the book's theses and the paradox the theses create (the "corporate law paradox"). Section B of Part I explores Easterbrook and Fischel's efforts to resolve the paradox. Section C then explains why, notwithstanding these efforts, the corporate law paradox is unresolved and their newly revised passivity thesis is flawed. Part II reopens the debate over what rules should govern target managements' response to tender offers, and suggests a possible resolution of the corporate law paradox, a resolution that involves *restructuring* corporate law.

---

13. *Id.* at viii.

14. Several of these topics have been addressed by each author independently. For instance, each has written two articles on insider trading. *See* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Frank H. Easterbrook, *Insider Trading as an Agency Problem*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 81 (John W. Pratt & Richard J. Zeckhauser eds., 1985); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 314-39 [hereinafter Easterbrook, *Insider Trading, Secret Agents*]; Daniel R. Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of* Dirks v. Securities and Exchange Commission, 13 HOFSTRA L. REV. 127 (1984).

15. CORPORATE LAW, *supra* note 2, at 2, 13; *see also id.* at 35-36 (professing indifference on individual firms' actual goals).

16. *Id.* at viii. The revisions are not always improvements. For example, the force of their famous *Corporate Control Transactions* is somewhat dissipated by being broken up over different chapters (Chapters 4 and 5). Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982).

I. HERESY IN HYDE PARK: EASTERBROOK AND FISCHEL V. THE MARKET

Long known for arguments in an astonishing array of independent debates, Easterbrook and Fischel make a more fundamental contribution in their book by providing a paradigm for understanding the corporation and the whole of corporate law.[17] They argue that corporate law can be understood only as a contract, and not just any contract: "No contract used in our society is more likely to satisfy the conditions for enforcing voluntary agreements."[18] Like contract law, corporate law's purpose is to provide the background or default terms to which the parties would have agreed were the costs of negotiating sufficiently low—that is, the terms that minimize agency costs between a firm's owners and its managers.[19] By providing efficient background rules, corporate

---

17. CORPORATE LAW, *supra* note 2, at 3-4. The contractual paradigm is outlined in the book's first chapter, which would make an excellent introduction to courses on corporations and securities regulation. *Id.* at 1-39. Such general explanations of their contractual paradigm may, in the long run, have the greatest impact. *See generally* THOMAS KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTIONS 43-51, 111-35 (2d ed. 1970).

18. CORPORATE LAW, *supra* note 2, at 24. While Easterbrook and Fischel self-consciously place themselves in the contractarian tradition, they are careful to distinguish theirs as an analysis of "real" contracts, rather than of "unreal" political or social contracts. *Id.* at 15-22. As we note later, it is unclear whether they consistently embrace "real" market contracts over those implied by their ideal analysis. *See infra* text accompanying note 99.

Much of the emphasis on contract is to be understood as a corrective to undue attention to the concept of "fairness." *Id.* at vii. They convey their analytical rejection of the concept by dismissively referring to it only inside of quotation marks. *Id; see also* Easterbrook and Fischel, *supra* note 16 (arguing that the fiduciary principle has little to do with "fairness"); Frank H. Easterbrook, *Abstraction and Authority*, 59 U. CHI. L. REV., 349, 350 (1992) ("Abstraction . . . may liberate courts from rules, license ex post appreciations and 'fair' divisions of the stakes.").

19. CORPORATE LAW, *supra* note 2, at 34. Its analysis builds upon the ideas of Ronald Coase, to whom the book is dedicated. (The book is also dedicated to their parents, to whom they affectionately refer as "necessary conditions of its existence." *Id.* at viii.) Unlike most law-and-economics scholars, they acknowledge a primary debt to Coase's analysis of the firm rather than to his later work on *The Problem of Social Cost.* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937), *reprinted in* R.H. COASE, THE FIRM, THE MARKET, AND THE LAW 33-55 (1988) [hereinafter Coase, THE FIRM]; R.H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960), *reprinted in* Coase, THE FIRM, *supra* at 95-156. In Coase's first great work, he showed that firms grow "until the costs of organizing production internally exceed the costs of organizing through market transactions." CORPORATE LAW, *supra* note 2, at 9. Because a corporation is distinguished only by the way it raises capital (i.e., issuing shares of stock as formal claims against future income) corporate law is the study of the marginal costs and benefits of this form of financing. The attraction of this method of raising capital is that it separates risk from employment, a form of division of labor. *Id.* at 10-11. These marginal costs are called agency costs and represent the monitoring, bonding, and residual costs associated with the divergence of shareholders' and managers' incentives. *Id.* at 10. "The corporation will flourish when the gains from the division of labor exceed the augmentation of the agency costs." *Id.* at 11. In short, corporate law is the study of the agency costs that arise from raising money by selling stock; "[t]he trick is to hold [these costs] as low as possible." *Id.* at 10; *see also id.* at 14 ("To understand corporate law you must understand how the balance of advantage among devices for controlling agency costs differs across firms and shifts from time to time. . . . Without answering difficult questions about the effectiveness of different devices for controlling agency costs, one cannot determine the appropriate allocation of rights.").

Easterbrook and Fischel intend the agency cost analysis to supplant the two paradigms that for years have been used to teach corporate law. First, this analysis is intended to supplant the less precise, though customary formulation that corporations are distinguished by the "separation of ownership and control." This phrase unduly implies that shareholders are controlled by management, whereas Easterbrook and Fischel emphasize the consensual nature of the relationship and thus their text speaks of the "separation of risk bearing from employment." *Id.* at 11. In addition, they claim that an emphasis on agency costs is more helpful than the customary incantation that the main features of a corporation are limited liability, legal identity, and

law spares most people the time and expense of negotiating. By usually providing *only* background rules, corporate law gives individual actors the flexibility they need to take advantage of their infinitely diverse circumstances. Various forms of competition assure that only socially beneficial arrangements survive. This then is the economic structure of corporate law: it maximizes society's wealth by providing default rules that mimic individuals' attempts to minimize agency costs.[20] From this view of corporate law's structure comes the book's two theses. In Easterbrook and Fischel's words: "The normative thesis of the book is that corporate law should contain the terms people would have negotiated, were the costs of negotiating at arm's length for every contingency sufficiently low. The positive thesis is that corporate law almost always conforms to this model."[21] We refer to the normative and positive theses together as the "efficiency thesis."[22]

While the efficiency thesis dominates their recent work, Easterbrook and Fischel dedicated much of their early careers to the "passivity thesis," which holds that shareholder wealth would be maximized if managers of a target firm were prevented from resisting tender offers.[23] According to the passivity thesis, target resistance is, for the following reasons, inefficient: it wastes resources,[24]

perpetual existence. *Id.* at 11-12. Their agency cost analysis is thus an attempt to reformulate our conception of the corporation.

20. Although the goal is reduction of agency costs, much of this is a transaction costs argument: People need not go to the trouble and cost of negotiating certain terms because the law has already provided these terms as "background terms." Agency costs themselves are reduced only when a term's transaction costs exceed its reduction in agency costs. We summarize this point in Table 1.

TABLE 1: *Efficiency Gains from Economic Structure of Corporate Law*

The Size of the Costs	Savings from the Structure of Corporate Law
Transaction Costs < Agency Cost Reduction	Transaction Costs
Transaction Costs > Agency Cost Reduction	Agency Costs

The genius of this structure is that it minimizes the sum of the agency and transaction costs associated with selling stock.

21. CORPORATE LAW, *supra* note 2, at 15.

22. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract, in* CORPORATE LAW AND ECONOMIC ANALYSIS 182 (Lucian A. Bebchuk ed., 1990).

23. The pure passivity thesis was first presented in Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) [hereinafter Easterbrook & Fischel, *Proper Role*], and was expanded in Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV 1 (1982) [hereinafter Easterbrook & Fischel, *Auctions*]. This proposition animated an astounding burst of creativity in the early eighties. Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155 (1982) [hereinafter Easterbrook & Fischel, *Antitrust*]; Frank H. Easterbrook & Daniel R. Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1981). Even their *Corporate Control Transactions* can be understood as part of the pure passivity project, because it attacks the idea that bidders should be forced to share the gains of the transaction with the targets. Easterbrook & Fischel, *supra* note 16, at 699.

24. Easterbrook & Fischel, *Proper Role*, *supra* note 23, at 1175 ("Indeed, because the process of resistance consumes real resources, shareholders as a whole lose by the amount targets spend in resistance

prevents assets from moving to their highest valued use, and raises agency costs. Of the three, Easterbrook and Fischel most emphasize the last. Resistance, by causing the bidder to pay more for the target, reduces gains from and investments in monitoring managements and searching for takeover opportunities.[25] Reduced monitoring lowers the probability that any disloyal management will be discovered and thus increases all managements' expected gains from shirking.[26] Thus, resistance makes all firms worse off.

To avoid these inefficiencies, Easterbrook and Fischel formerly argued that a rule of target passivity must be made mandatory for all firms: "Our investigation leads to the conclusion that shareholders' welfare is maximized by an *externally imposed legal rule* severely limiting the ability of managers to resist a tender offer."[27] Surprisingly, Easterbrook and Fischel have quietly made a fundamental change in their passivity thesis. They now recommend passivity only as a *default* rule: "[T]he optimal legal rule prevents resistance unless expressly authorized by contract *ex ante*."[28] Thus, in its current form, their passivity thesis allows firms to adopt takeover defenses (if done prior to a bid.)[29] While they do not highlight it,[30] this position represents a significant, if reluctant, change from the authors' earlier writings.[31] Still, the book makes

---

plus the amount bidders and any rivals spend in overcoming resistance. These additional costs can be substantial.") (citation omitted).

25. *Id.* at 1176-77 ("The [resistance which brings a] resulting increase in the prices paid for target firms will generally discourage prospective bidders for other targets. . . . [T]hat affects the size of agency costs and in turn the pre-offer price of potential targets' stock."); *see also* Alan Schwartz, *Search Theory and the Tender Offer Auction*, 2 J.L. ECON. & ORGANIZATION 229 (1986) (making the distinction between static and dynamic inefficiencies that may result from target resistance).

26. CORPORATE LAW, *supra* note 2, at 43 ("A rule that facilitates transfers of control also induces managers to work more effectively to stave off such transfers."); Easterbrook & Fischel, *Auctions, supra* note 23, at 2 ("By raising the price, auctions reduce the number of acquisitions and thus the amount of monitoring. The decrease in monitoring results in higher agency costs of management and thus in lower returns on investment."); Easterbrook & Fischel, *Proper Role, supra* note 23, at 1174 ("More significantly, for our purposes, shareholders benefit even if their corporation never is the subject of a tender offer. The process of monitoring by outsiders poses a continuous threat of takeover if performance lags.").

27. Easterbrook & Fischel, *Proper Role, supra* note 23, at 1164 (emphasis added). This change is likely in response to the criticisms made in David N. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987).

28. CORPORATE LAW, *supra* note 2, at 174.

29. *Cf.* Haddock et al., *supra* note 27, at 736 ("No legal rule in this area can be optimal unless it is an option.").

30. Indeed, one reviewer missed the change entirely. Book Note: *Dr. Pangloss Meets the Coase Theorem*, 105 HARV. L. REV. 1408 (1992). In fact, the word "passivity" is conspicuously absent, and the book makes not one reference to the articles in which Easterbrook and Fischel make the case for passivity. This seems odd given that those articles constitute their most influential work. Federal courts cite the articles that outline the pure passivity thesis more often than all their other articles combined. For instance, a LEXIS search revealed thirty-two opinions citing their joint work. Of these opinions, nineteen cited their arguments regarding the inefficiency of resistance (including Easterbrook & Fischel, *Antitrust, supra* note 23).

31. However, it is not clear even in the book to what degree their view has changed. For instance, Chapter One suggests that they still desire a *mandatory* rule of pure passivity. After establishing, by hypothesis, that pure passivity is the efficient ex ante rule, they give reasons explaining why it may not arise by contract. Thus, they state that this "may mean that the contracts actually adopted [regarding corporate response to takeovers] are not optimal. This may mean that legal rules can improve on the corporate contracts." CORPORATE LAW, *supra* note 2, at 26-27. This last sentence seems to contemplate a mandatory rule. *See also id.* at 204 ("*Every* device giving managers the power to delay or prevent an acquisition makes

clear that Easterbrook and Fischel have by no means abandoned—though they have slightly revised—their passivity thesis. This creates a fundamental paradox in their work.[32]

A. *The Paradox: Things Fall Apart; The Center Cannot Hold*[33]

Although the passivity and efficiency theses are analytically compatible, they become paradoxical upon examining empirical evidence. If pure passivity *is* efficient, it should emerge as a rule of law or, at least, a surviving contractual term, because it affects a firm's governance and "[t]here is no substantial impediment to the operation of the competitive process at the level of structure. The pressures that operate in the long run are exactly the forces that shape structure."[34] Throughout the book, Easterbrook and Fischel identify a number of important corporate contracts or institutions providing legal rules that mimic contracts. Surprisingly, *not one* of these sources of efficient rules has produced pure passivity (or even substantial passivity); pure passivity is simply *nowhere* the contractual solution for the behavior of target boards. Instead, each contractual source of law allows (and sometimes obligates a target board's use of) a wide array of defenses. This is particularly troubling for the efficiency thesis, as Easterbrook and Fischel repeatedly remind us that surviving and widely used terms are optimal for society.[35] As Professors Haddock, Macey, and McChesney first noted, passivity, although possible to achieve contractually, is not the market's solution to agency costs.[36] In sum, the passivity thesis

shareholders worse off.").

32. In other ways as well, the relationship of the book to their previous work is not free from tension. For instance, they reverse their position on the constitutionality of state takeover laws. *Compare*, Easterbrook & Fischel, *Proper Role*, *supra* note 23, at 1163 n.8 ("to the extent that state statutes are less hospitable to hostile takeover bids than the Williams Act, they are of doubtful constitutionality") *with* CORPORATE LAW, *supra* note 2, at 223-27 ("Just as the Constitution 'does not enact Mr. Herbert Spencer's *Social Statics*,' so it does not enact the efficient capital market hypothesis or turn the latest issue of the *Journal of Financial Economics* into the law of the land.") (quoting Lochner v. New York, 198 U.S. 45, 75 (1905) (Holmes, J., dissenting)).

33. "Turning and turning in the widening gyre/The falcon cannot hear the falconer/Things fall apart; the center cannot hold/Mere anarchy is loosed upon the world." WILLIAM BUTLER YEATS, THE COLLECTED POEMS OF WILLIAM BUTLER YEATS 187 (Richard J. Finneran ed. 1989). For the relevance of anarchy, see *infra* text accompanying note 264.

34. CORPORATE LAW, *supra* note 2, at 7.

35. *Id.* at 6-7 ("Any one firm may deviate from the optimal measures. Over tens of years and thousands of firms, though, tendencies emerge.... Because the choices do not impose costs on strangers to the contracts, what is optimal for the firms and investors is optimal for society. We can learn a great deal just by observing which devices are widely used . . . .").

36. Haddock et al., *supra* note 27, at 704. This important article noted that intrafirm contracts, and competition between those who provide rules for corporations (i.e., stock exchanges), should be able to produce passivity if it is efficient. We extend this analysis to other forms of law Easterbrook and Fischel consider contractual. Although this Subsection considers only two (charters and state corporate law), the same paradox is replicated in all of the sources they trumpet as contractual and efficient, such as voting and the common law. Easterbrook and Fischel tell us that the "*structure* of voting—who votes, using what institutions—is contractual, and efficient too," and that votes efficiently fill in the details left open by contract. CORPORATE LAW, *supra* note 2, at 63, 66. The right to vote is thus characterized as powerful and one that maximizes the value of the firm:

contradicts the efficiency thesis. This paradox is present in all of the contractual sources of law.

1. *Articles of Incorporation*

Corporate charters present the strongest case for Easterbrook and Fischel's efficiency thesis. Although written by management, charters are contractual because their terms are impounded in the price of the stock sold to willing buyers and efficient because their terms will be written to maximize stock price. "[S]elf-interested entrepreneurs . . . just like other investors, are driven to find the devices most likely to maximize net profits. If they do not, they pay for their mistakes . . . ."[37]

If efficient terms of law are going to emerge anywhere, they will emerge in corporate charters: the incentives of managers, entrepreneurs, and shareholders are thought to be most closely aligned; the contents of charters are public knowledge and easier to value than new projects;[38] and there are no expensive impediments to the competitive process' impact on firms' structures.[39] Thus, although shareholders never sit down and haggle over the terms of corporate charters, corporate charters are written as if they did.

Thus, accepting Easterbrook and Fischel's efficiency thesis, we would expect the terms of corporate charters to be efficient[40] and, following the passivity

---

> These rules denying tenure to the board *put the voters firmly in control*—should they choose to exercise it—at any time and ensure that the residual claimants have the final say. *Managers may be given the quick boot if agency costs become unacceptable.* It is true that in public corporations directors are rarely evicted in midterm, but the possibility of ouster may be sufficient to ensure that directors act as faithful agents of the residual claimants.

Id. at 76 (emphasis added). Given this emphasis, one would expect voting to yield efficient corporate governance structures. It has not. Collective action problems alone do not explain this failure: the empirical evidence is that voting does little to check management even when information is inexpensive and shareholders attention is focused. *See* John Pound, *Proxy Contests and the Efficiency of Shareholder Oversight*, 20 J. FIN. ECON. 237 (1988).

The same is true for the common law, which Easterbrook and Fischel call efficient and even contractual (i.e., impounded in the price of contracts) because courts supplement contracts with efficient default rules. Put differently, Easterbrook and Fischel offer

> a contractual way of looking at the corporation. This formula is the one courts use to fill the gaps in explicit contracts that inevitably arise because it is impossible to cover every. . . . The gap-filling rule will call on courts to duplicate the terms the parties would have selected, in their joint interest, if they had contracted explicitly.

CORPORATE LAW, *supra* note 2, at 22. Thus, judges are characterized as selecting efficient default terms such as the managers' fiduciary duty. Nevertheless, passivity has never arisen via the common law's setting of default terms. In fact, one of the more surprising aspects of the book is that courts are not more harshly criticized for this failure to enforce efficient behavior in takeover litigation. The lone exception to the apparent rule of deference is their evaluation of the Delaware's "fundamental value" reasoning: "Not a scrap of data supports the position taken in Delaware cases. It is depressing to see 'earth is flat' reasoning from our premier corporate court." *Id.* at 207.

37. *Id.* at 6; *see also id.* at 4-5 & 7.

38. *Id.* at 21.

39. *Id.* at 7.

40. *Cf.* Steven Shavell, *The Design of Contracts and Remedies for Breach*, 99 Q.J. ECON. 121 (1984) (freely negotiated contracts will maximize total gains to contracting); Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980) (same).

thesis, to require target passivity. Contracts obligating the corporation to respond passively to a tender offer would be easy to adopt. For instance, a charter provision might require passivity unless otherwise ratified by a supermajority of the stockholders at consecutive shareholder meetings—between which a takeover could occur.[41]

Such passivity contracts do not exist, however.[42] Consider, for instance, a parent company contemplating spinning off a division and selling it as a separate company—the situation that best approximates the ideal contracting conditions imagined by Easterbrook and Fischel.[43] The sole shareholder of the nascent company is sophisticated and well advised. Thus, there are no collective action problems to prevent shareholder interests from being reflected in the charter. The managers of the parent company specify the terms of the charter and are free from unjustified concern for the job security of the managers of the company that is spun off. Given such ideal circumstances, the corporate charters of the spun-off companies should contain efficient terms. Strikingly, such contracts never require passivity, but do sometimes contain significant shark repellant provisions.[44] Shareholders' apparent rejection of passivity can be seen even in the actions of firms whose charters say nothing about management's response to a tender offer: absent a pure passivity contract, it must be assumed that investors have chosen to allow their agents the option to resist takeovers. The absence of a term preventing defensive tactics is, in effect, a positive term authorizing them.[45]

41. CORPORATE LAW, *supra* note 2, at 33-34; Haddock et al., *supra* note 27, at 729-733 (more fully describing devices by which firms can credibly bond a promise of passivity). Note that there is no reason why the amendment process for other provisions need be equally hampered. Thus, the argument that corporations need flexibility to respond to the wide variety of circumstances is not germane. Corporate contracts may be drawn with sufficient precision to prevent some of the more egregious defenses, and yet they are not. *See also* Ian Ayres, *Making A Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. (forthcoming 1992).

42. Easterbrook and Fischel recognize as much. Easterbrook & Fischel, *Proper Role*, *supra* note 23, at 1180 ("The shareholder trying to choose a set of instructions to management consequently would conclude that his welfare is best served by instructions to acquiesce. Such instructions give managers the greatest incentives to perform optimally. . . . Yet articles of incorporation rarely if ever contain antiresistance provisions. To the contrary, they sometimes contain provisions to make acquisition difficult. Classified boards, cumulative voting, supermajority consent rules, and similar provisions may frustrate the tender offeror's attempts to take control after it has purchased a majority of the common stock."); Haddock et al., *supra* note 27, at 704 (few, if any, firms contract to passivity) (citations omitted). The absence of passivity contracts thus persists years after academics showed how such contracts could create target passivity.

43. We are indebted to Steve Fraidin for this point.

44. It is rumoured that the spin off of Allergan fell into this category. *See generally Allergan Shareholders Sue SmithKline Beecham*, Reuters, Sept. 20, 1989, *available in* LEXIS, Nexis Library, Omni File.

45. CORPORATE LAW, *supra* note 2, at 22 ("It promotes clear thought to understand that the silence or ambiguity in corporate documents is itself a problem of contract, one the parties could solve if they wished and if the costs of negotiating were worthwhile in light of the stakes."). Easterbrook and Fischel elsewhere argue that corporations should be allowed to opt out of much of corporate law because the original price of the shares would reflect the possibility that such opting out might occur. Thus, they too argue that the absence of a prohibition is an authorization; defensive tactics are nothing if not predictable. *Id.* at 142.

The fact that passivity—"the contract that (by hypothesis) was optimal at the beginning"[46]—has not *emerged* at the firm's beginning calls either Easterbrook and Fischel's corporate law thesis or their passivity thesis into question.

2. *State Law*

Ever since Ralph Winter's classic response[47] to William Cary,[48] scholars have been arguing whether states, to attract incorporation fees, are racing for the top, for the bottom, or not at all. This incorporation debate seeks to answer whether or not state law is likely to be efficient. In an important sense, Easterbrook and Fischel borrow from and build upon this debate. The book's introduction poses Cary's question: why should self-interested managers be allowed to select the laws that will govern their own behavior? Following Winter, they answer that an "invisible hand" will align managers' interests with those of shareholders. Competitive pressures force managers to choose the laws that maximize investors' wealth:

> Managers in the United States must select the place of incorporation. The fifty states offer different menus of devices . . . for the protection of investors. The managers who pick the state of incorporation that is most desirable from the perspective of investors will attract the most money. The states that select the best combination of rules will attract the most corporate investment (and therefore increase their tax collections). So states compete to offer—and managers to use—beneficial sets of legal rules [and governance structures].[49]

Because Easterbrook and Fischel believe that default terms are so important, their theory predicts that natural selection will favor firms that incorporate in states whose default terms are most efficient. Thus, another way to state the efficiency thesis is that the most successful firms will be governed by efficient default rules—a notion quite similar to, and in part dependent upon, Winter's initial "race for the top" logic.[50]

In short, because the incorporation debate seeks to determine the efficiency of state laws, it directly implicates Easterbrook and Fischel's efficiency thesis. With that thesis at stake,[51] they review the current literature and conclude, with

46. *Id.* at 26.

47. Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

48. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

49. CORPORATE LAW, *supra* note 2, at 5-6.

50. Winter has modified his original position. Ralph K. Winter, Jr., *"The Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526 (1989).

51. Strictly speaking, their thesis does not require that every single law be efficient. *See infra* text accompanying note 56. However, while the validity of the thesis may not depend on its scope, its relevance may. The usefulness of the corporate law thesis may depend on how efficient corporate law is, and whether

admirable candor, that current evidence is "embarrassing" for the "fundamental thesis of this book."[52] Current antitakeover laws are doubly embarrassing for Easterbrook and Fischel. First, these laws reveal the inefficiency of state laws inasmuch as they deter takeovers and thus increase agency costs. Second, these laws reveal the extent of the inefficiency of corporate charters because the inefficiency of state common and statutory laws should give shareholders even more incentive to create management passivity via contract. The fact that management's defensive tactics are still not limited by charters suggests that such *contracts* are unresponsive, a failure that cannot be explained by saying that *statutory law* is not perfect. Thus, antitakeover laws embody the corporate law paradox:[53]

> At this point two of our themes run headlong into each other. We have said repeatedly that corporate law works like a standard-form contract in promoting the wealth of investors. [The previous chapter] concludes that the rules concerning takeovers have the opposite effect. Which is it to be? Is corporate law efficient or not? Things look even darker for the efficiency thesis because during the last twenty years some forty states have enacted one or another form of antitakeover legislation. If these state laws injure investors, how about others?[54]

Easterbrook and Fischel discuss a number of possible efficiency explanations for the antitakeover laws that would resolve the contradiction, but ultimately reject them all. By process of elimination, they are left with the unfortunate conclusion that the statutes can only be explained by the fact that they "facilitate managers' entrenchment, a version of Cary's hypothesis . . . ."[55] Thus, state antitakeover laws are strong evidence that the efficiency of corporate law is, at best, limited.

The chapter's moderation is impressive. The authors candidly note the contradiction and their unfortunate conclusion. Their willingness to concede weakness, as any good trial attorney will verify, makes their overall message more credible. It also makes it incomplete. Unfortunately, Easterbrook and Fischel never fully explore the implications of this evidence for the positive facet of the efficiency thesis other than to retreat to the more modest claim that

---

the thesis can predict the efficiency of particular areas of law. *See infra* notes 261-65.

52. CORPORATE LAW, *supra* note 2, at 221. Unfortunately, they do not give a general account of this anomaly and, at any rate, do not predict if and when other anomalies are likely to occur.

53. In Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496 (7th Cir. 1989), Judge Easterbrook noted that "[i]f our views of the wisdom of state law mattered, Wisconsin's takeover statute would not survive. Like our colleagues who decided *MITE* and *CTS*, we believe that antitakeover legislation injures shareholders. . . . State anti-takeover laws do not serve these [wealth maximizing] ends well . . . ." *Id.* at 500-01.

54. CORPORATE LAW, *supra* note 2, at 212.

55. *Id.* at 220 (also noting their last-period problem modification of Cary's thesis).

state law will not be perfectly efficient.[56] While perhaps accurate, it is also unsatisfying: because they have devoted so much of their careers to arguing the efficiency of corporate law, such an important exception calls for an explanation. Those who subscribe to the passivity thesis may well conclude that evidence of such important inefficiencies well nigh disproves the efficiency thesis. In any event, because the authors never discuss why antitakeover laws might be a special case, the book leaves readers with the imprecise notion that corporate law is sometimes efficient and sometimes not.[57]

B. *The Paradox Unresolved*

Curiously, Easterbrook and Fischel never attempt a straightforward resolution of the corporate law paradox. The conflict is recognized, but is addressed only obliquely in two new sections outlining the "limits of contract."[58] In their attempt to resolve the tension between the two theses, Easterbrook and Fischel: (1) defend the passivity thesis by giving reasons why, even if efficient, it does not arise by contract; and (2) change the passivity thesis—making it enabling instead of mandatory. As made clear in this Section and the next, neither tactic is successful.

If they are to preserve both the passivity and efficiency theses, Easterbrook and Fischel must specify market imperfections that explain why pure passivity, if efficient, does not emerge. As they express it:

> Unless the person challenging the portion of the corporate contract [that allows defensive tactics] can make a convincing argument that the consequences of the term could not have been appreciated by investors and priced efficiently, there is no reason for intervening to correct a

---

56. To buttress the efficiency thesis, Easterbrook and Fischel also suggest that Delaware's delay in adopting an antitakeover law might be "indicative" and that, in the long run, antitakeover statutes may yet prove transient. *Id.* at 222-23; *see also id.* at 150 ("Appraisal statutes to this extent diverge from the ideal [wealth maximizing] description of them we gave in Chapter 5. (But then we have never contended that state laws are perfectly designed to promote investors' wealth, only that the structure of corporate law is well designed.)"); *id.* at 222 (the authors' thesis requires, not perfection, but "a powerful tendency for states to enact laws that operate to the benefit of investors (the opposite of the Carey view) . . . .").

57. Easterbrook and Fischel never fully explain the implications of this exception for their corporate law thesis, but focus instead on its implications for the "race for the top" thesis. Other scholars, building upon their work, may provide the answers. Perhaps this is the exploratory area at which they hinted in the beginning. *Id.* at vii-viii. Nevertheless, this is an important gap. The debate over the limits of the "race for the top," and the corporate law thesis, appears to us to be the fundamental debate in corporate law. Yet, with the notable exceptions of Lucian Bebchuk and Roberta Romano, few have added to this debate in the fifteen years since Ralph Winter's article. *See* Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV 1820 (1989); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORGANIZATION. 225 (1985). *See also* Ayers, *supra* note 41.

58. CORPORATE LAW, *supra* note 2, at 22-35, 167-71. As described *supra* note 57, Easterbrook and Fischel wrestle with the paradox insofar as it implicates statutory rules and the "race for the top." *Id.* at 212-27.

mistake. . . . [Otherwise,] the presumptive hypothesis is that the mistake has been made by the critic, not by the firm and the investors.[59]

This is no easy task. First, they must not prove too much—arguments that shareholders do not appreciate the cost of a particular term undercut the efficiency thesis. Second, they may have already proved too much, having shown that investors evaluate and anticipate defensive tactics.[60]

We now assume the truth of the passivity thesis and examine whether the specified limits of contract account for the absence of passivity.

1. *Regulatory Interference with Contracts*

One reason why efficient terms may not emerge via contract is that the law sometimes prohibits them. In such instances, a term's absence does not evidence its inefficiency. Easterbrook and Fischel suggest that passivity may be such a term, given that "[t]he securities laws do not permit potential bidders to line up extensive portfolios of call options, so that they could [avoid management resistance and] acquire a firm on a moment's notice."[61] Thus, "[t]he impracticality and illegality of an important contractual device may mean that the contracts actually adopted are not optimal. This may mean that legal rules can improve on the corporate contracts."[62]

Although regulatory interference may explain the absence of passivity contracts between shareholders and *bidders* (contracts external to a firm's governance structure), it cannot explain the absence of passivity contracts between shareholders and *managers* (contracts internal to a firm's governance structure). A firm's internal governance structures are not comparably regulated.[63] Because Easterbrook and Fischel do not specify how regulation interferes with a firm's internal governance structures, the problem of passivity remains. That we do not live in a "world of completely free contracting"[64] is no resolution of the paradox.

59. *Id.* at 31. Easterbrook and Fischel note that the absence of a term also may reflect the intent of the parties. *See supra* note 45 and accompanying text. Thus, the absence of a pure passivity term suggests that shareholders intend managers to have the freedom to adopt defenses. *Id.* at 142 (if terms are easy to reach but unobserved, current law presumably furthers shareholders' interest). Because defensive tactics, such as poison pills, are ubiquitous, it is a fair assumption that any firm will probably adopt defenses given the opportunity.

60. *Id.* at 34 ("Investors can and do appreciate the risk that latecomer terms will be damaging . . . ."); *id.* at 196-98 (cataloging the price depressing effect of the adoption of defenses).

61. *Id.* at 168; *see also id.* at 26-27.

62. *Id.* at 27. This is technically not a market failure but a regulatory failure that inhibits contracts.

63. *See supra* notes 41-42 and accompanying text (describing charter provisions that would make management resistance more difficult). Corporate contracts that may result in pure passivity are explained more fully in Haddock et al., *supra* note 27, at 727-32.

64. CORPORATE LAW, *supra* note 2, at 168.

2. *Ex Ante Contracting Costs*

Easterbrook and Fischel suggest at one point that ex ante contracting costs may be to blame for the failure of passivity to arise via contract. Although never completely clear on the topic, they seem to argue that passivity is an efficient, but not a practical contract term.[65] First, costs may prevent shareholders from contracting with bidders. As they put it: "If it were possible to contract in advance with bidders, investors could restrain themselves from adopting new strategies when it looks like a bid is in prospect. Such [contracts] turn out to be . . . impractical (because they imply contracts with a world of potential bidders, at prohibitive transaction costs) . . . ."[66] Thus, we are told, "[e]ven if all contracts were lawful, they might not be practical."[67] Second, ex ante costs may also explain why shareholders have not insisted on passivity as a term of the corporate charter.[68] As an alternative to costly contracts regarding management behavior when faced with unsolicited bids, corporate law provides arrangements for ex post settling-up,[69] such as voting mechanisms and fiduciary duty rules.[70] For a number of reasons, however, neither of these contracting-cost arguments resolves the paradox.

The first argument, like the argument about regulation, depends on an implicit assumption that achieving passivity by contract requires that investors strike separate bargains with each and every potential bidder. This is obviously not the case, for investors can contract with managers and, in effect, with *all* potential bidders in a single contract—the articles of incorporation.[71]

The second argument wrongly suggests that corporate law efficiently fills in the gaps left by costly contracts. Yet, because neither of the specified ex post settling-up mechanisms have pushed managements toward passivity,[72] share-

65. *Id.* at 26-27, 168. This also is a double-edged sword, for ex ante contracting costs that justify the absence of passivity also may be used to claim that ex ante corporate contracts are, in general, inefficient or incomplete in important ways.

66. *Id.* at 26-27.

67. *Id.* at 168.

68. *Id.*

69. *See* CORPORATE LAW, *supra* note 2, at 7. *See generally* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1108-09 (1972).

70. *See* CORPORATE LAW, *supra* note 2, at 7, chs. 3 & 4.

71. *Id.* at 168, 205. Even if contracting did have to take place with only one potential bidder at a time, a passivity contract with just one potential bidder would yield the same kind of benefits that Easterbrook and Fischel hope for, though perhaps to a lesser degree. Indeed, if the one potential bidder's contractual right were transferable, as the potential target would have every incentive to ensure, then the magnitude of the benefits of even just the one contract may well approach those of Easterbrook and Fischel's general rule. *See generally* Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). Thus, even if contracting were limited as Easterbrook and Fischel suggest, we would still expect to see some contracting to passivity.

72. *See supra* note 36 and *infra* note 126.

holders would make a passivity term explicit if passivity were efficient.[73] They do not.

Moreover, the very premise of this transaction costs argument is doubtful. Others have argued that passivity contracts would be quite inexpensive.[74] Even assuming that contracting costs are substantial, Easterbrook and Fischel offer no explanation for why firms so commonly contract away from passivity. If, as they suggest, contracting costs are the only thing that comes between shareholders and efficient contracts, then investors should write contracts that are as close to pure passivity as is practical. Instead, actual contracts suggest that investors are willing to go out of their way to give managers the ability to resist takeover attempts or, the rough equivalent, the ability to create the ability to resist.

Easterbrook and Fischel suggest further that both of these ex ante contracting-cost problems may be heightened by free-rider problems.[75] Individual firms may be unwilling to make the initial investment in writing a detailed contract in light of the fact that competing firms could simply copy the contract at comparatively little expense. For two reasons, however, free-rider problems are unlikely to be significant. First, the private gains to such a contract would be significant regardless of any free-riding. If Easterbrook and Fischel are correct, such contracts could bring shareholders billions of dollars,[76] a gain surely great enough to merit substantial investment. Second, if enough firms demand such a contract, legal entrepreneurs could largely overcome any free-rider problems through the sale and resale of the expertise and reputation gained in its development. Any existing free-rider problems therefore should be no larger than those overcome by firms contracting *away* from passivity.[77]

---

73. *See supra* note 59.

74. Haddock et al., *supra* note 27; Ayres, *supra* note 41. In addition, it is not clear why the ex ante costs of contracting for pure passivity would be substantially greater than the ex ante costs of contracting for defenses. It should be no more costly to create staggered boards than to prevent them. Obviously, it would be very costly to contract for pure passivity in all circumstances, but there are many defenses that should be easy to prohibit by contract. The more notorious and conventional the defense, the easier it is to prevent. Charters should be able to define, and thus prevent, such well established defensive tactics as the sale of the crown jewels, the issuance of shareholder's rights plans (i.e., poison pills), and target litigation against the bidder. Conventional defensive tactics appear to be preventable at little cost, yet even these defenses are not banned by contract. *See also supra* notes 41-42 and accompanying text.

75. CORPORATE LAW, *supra* note 2, at 35 ("No one firm could capture all of the gains from working out all problems in advance, because other firms could copy the answers without paying the creator. If the value of new solutions is hard to appropriate, and if the gain from private bargaining is small, people will leave things to be worked out later.").

76. *Id.* at 204 (describing the billions of dollars in losses caused by antitakeover devices).

77. One need only glance at the money made by Marty Lipton and others at Wachtell, Lipton, Rosen & Katz (the inventors of the poison pill) to see the net rewards that await legal inventions affecting corporate governance. *See, e.g., Supplement: The Am Law 100*, THE AMERICAN LAWYER, July-Aug. 1992, at 31.

3. *Ex Post Contracting Costs*

Easterbrook and Fischel also describe four types of ex post contracting costs, suggesting that these costs explain why passivity, though desirable, does not arise by contract. These suggestions, however, are undermined by their own arguments elsewhere in the book.

First, they argue that, even if "every detail could be negotiated *ex ante*," a contract may still not be enforced ex post.[78] To support this contention, Easterbrook and Fischel describe a contract that requires managers faced with a takeover to auction the firm for the highest price but prevents them from seeking to preserve independence.[79] They explain that such a contract would be unenforceable because many of the steps necessary to facilitate an auction may also facilitate resistance. As a result, it would be difficult to determine whether the managers were auctioning the company or resisting the change of control.[80]

There are several problems with this argument, however. First, the contract clause they describe is hardly an example of a contract in which "every detail" is negotiated ex ante. The enforceability problem that they claim to identify seems more the *consequence*, not the cause, of imperfect contracting. Their example is further undermined by the fact that the purported enforceability problem seems never to have actually occurred. It is quite a stretch to claim that because courts may sometimes fail to enforce an efficient contract term, investors will *never* include it. After all, the clause would sometimes be easy for courts to interpret and enforce.[81] Also, since courts are left to their own (inefficient) devices in the absence of such a clause, the clause would at least serve the function of signalling the parties' intent.

Even assuming Easterbrook and Fischel's description of the difficulties of enforcing their hypothetical contract is accurate, it is of little use in resolving the paradox. Their example illustrates why it is difficult to write contracts that ensure a moderate amount of *resistance*. Because pure passivity is a rule that is relatively easy to write and enforce, the difficulties inherent in enforcing the hypothetical contract argue for passivity—not its absence.

Finally, as we will see with most of Easterbrook and Fischel's ex post contracting arguments, they themselves have made contradictory claims. In this case, for instance, they argue elsewhere in the book that "[i]t is easy to write

78. CORPORATE LAW, *supra* note 2, at 169.

79. *Id.*

80. *Id.*; *see also* Easterbrook & Fischel, *Proper Role*, *supra* note 23, at 1175.

81. *See* Easterbrook & Fischel, *Proper Role*, *supra* note 23, at 1202-03 ("Under our view that managers should be passive in response to a tender offer, *Marshall Field* is an easy case . . . ."). *Id.* at 1203-04 (while there may be close calls under such a regime, they will be relatively infrequent and simple).

the articles of incorporation (or poison pill securities) to facilitate auctions while tying managers' hands."[82]

Easterbrook and Fischel suggest a second ex post contracting problem: "[T]erms optimal when adopted may not be optimal given a bid."[83] They write:

> Firms that have made themselves easy to take over, so as to maximize the probability of a bid, find that once a bid appears it is profitable to provoke an auction. Perhaps it will issue a friendly bloc of stock or a lock-up auction. . . . Preventing such opportunistic switches is next to impossible.[84]

The problem with this argument is that they argue elsewhere in the book that "preventing such opportunistic switches" is straightforward. They concede that if such opportunistic switches are a problem, shareholders can adopt a pre-commitment device by contract "if such a constraint on amendments is beneficial to investors."[85] In short, contracts as well as statutes can

> provide that terms in place at the beginning (at the time the firm is founded, goes public, or issues significant amounts of stock) are always to be honored unless there are demonstrable third party effects, while terms adopted later that appear to increase the agency costs of management [such as provisions allowing resistance] are valid only if adopted by supermajority vote at successive annual meetings or if dissenting investors are bought out. (The dual meeting rule would allow an intervening proxy or takeover contest to prevent the change from going into effect.)[86]

They further argue that "[i]f a state is clever, it allows . . . entrepreneurs to opt out of [an antitakeover] statute, making credible commitments to serve investors faithfully by exposing themselves to ouster."[87] There is thus a variety of means by which shareholders can credibly commit to pure passivity in return for the market's increased monitoring.

Easterbrook and Fischel make a related argument regarding a third ex post contracting problem, "latecomer terms." Some defensive provisions are inserted after the "beginning" (for example, a firm's founding, initial public offering, or stock issuance) and therefore may not be efficient because they do not pass the market test. Thus, latecomer terms may be immune from evolutionary and competitive pressures because "[t]he mechanism by which entrepreneurs and

82. CORPORATE LAW, *supra* note 2, at 205.
83. *Id.* at 169.
84. *Id.*
85. *Id.* at 33-34.
86. *Id.* at 33. This dual meeting term would assure passivity by allowing time for a hostile bid to be made before defenses could be adopted.
87. *Id.* at 222.

managers bear the cost of unfavorable terms does not work" for such terms.[88] Again, however, Easterbrook and Fischel's argument neglects their own persuasive counter-argument. In the first chapter, Easterbrook and Fischel note the theoretical problem raised by inefficient latecomer terms and that it could be solved by requiring suspect latecomer terms to pass stringent tests such as dual meeting and supermajority vote requirements.[89] However, after concluding this theoretical argument, they note that the empirical evidence of the market is inconsistent with the existence of a serious latecomer problem: "if such constraints on amendments [and latecomer terms] are beneficial to investors, why are supermajority and dual meeting requirements so rare in corporate documents? Investors can and do appreciate the risk that latecomer terms will be damaging."[90] Thus, Easterbrook and Fischel undercut, on their own, the idea that latecomer problems create inefficiencies contract cannot solve.[91]

The final potential ex post explanation for the absence of passivity is the "last-period" argument: when managers have gone to the capital or labor markets for the last time, they are free to "dig in their heels" and pursue their interests at shareholders' expense.[92] However, resistance is *not* a last-period problem. It arises at the firm's inception when the firm decides to allow or prevent defenses. Given the ubiquity of takeover defenses and the ease with which they may be adopted, the failure to prevent defenses is, in effect, a term of the corporate charter that allows them.[93] Thus, passivity is a first-period problem and arises when the interests of shareholders, managers, and entrepreneurs are most closely aligned.[94]

88. *Id.* at 32.

89. *Id.* at 33. Elsewhere in the book they hint that this problem should be remedied by appraisal rights to compensate investors for "unanticipated changes in the articles, by-laws, and structure of securities that change the risk or expected return of investment. We expect continuing expansion in the scope of appraisal as firms and their lawyers become increasingly creative in altering the risk-return attributes of investment." *Id.* at 161.

90. *Id.* at 33-34.

91. They do make two half-hearted attempts to avoid the conclusion that contracts can solve latecomer problems. First, they remark that "perhaps rules that slow down the adoption of changes would be more damaging still on balance" than the dangers they would avoid. *Id.* at 34. Yet this simply suggests that the dangers of management resistance and the benefits of pure passivity are not as great as we would have believed given the tenor of their other writings. This is especially curious because there is no reason why the dual meeting, supermajority vote requirements could not be specifically designed to prevent some of the more obvious defensive tactics, while leaving management able to respond to normal business opportunities. Second, they leave the apparent contradiction unresolved because "[i]t is not our purpose here to draft rules of law." *Id.* This is uncharacteristically agnostic. They clearly *do* advocate a particular rule of law, namely a default rule of target passivity: "[T]he optimal legal rule prevents resistance unless expressly authorized by contract *ex ante*." *Id.* at 174.

92. *Id.* at 169.

93. *See id.* at 142 ("Although it should be relatively easy to reach such [corporate opportunity] contracts, they appear to be rare, which suggests that shareholders' interests coincide with existing legal rules."); *see also supra* notes 44-45, *infra* notes 102-03 and accompanying text.

94. *Id.* at 6 ("To sum up: self-interested entrepreneurs and managers, just like other investors, are driven to find the devices most likely to maximize net profits."). Some firms going public, an event classified as the firm's "beginning," choose the state of incorporation for the express purpose of increasing takeover protection. Interview with a Director of Franklin Quest, in New Haven, Conn. (June 1, 1992).

In sum, Easterbrook and Fischel's discussion of ex post contracting problems leaves the corporate law paradox intact.

4. *The Efficiency of Resistance?*

Easterbrook and Fischel suggest a final possibility that could be taken as a justification for the absence of passivity. Perhaps recognizing the weaknesses in their other arguments, but hoping nevertheless to resolve the paradox, they make an argument they have all but repudiated throughout the last decade. Out of nowhere, and only for a moment, Easterbrook and Fischel admit that pure passivity may be *inefficient* for some firms:[95]

> Some firms may be managed best if guaranteed "independence"—not only from bidders but also from meddling by their own investors. Perhaps tenure for managers promotes long-run planning at some firms. Perhaps the ability to keep a firm independent will assist managers in negotiating the best terms for any given acquisition.[96]

Unfortunately, this seemingly last-ditch attempt to resolve the corporate law paradox also fails. If, as an empirical matter, passivity is usually efficient—and this must be Easterbrook and Fischel's view given that they call for a pure passivity background rule—they still have not explained why a *majority* of firms have not contracted to passivity. The paradox remains. On the other hand, if passivity is typically inefficient, then the corporate law paradox is resolved only by jettisoning the passivity thesis. But since Easterbrook and Fischel want to hold fast to both theses, the paradox persists.

---

95. One of the book's recurrent themes is that optimal contract arrangements vary across firms and time. CORPORATE LAW, *supra* note 2, at 5 ("No set of promises is right for all firms at all times. . . . We should be skeptical of claims that any one structure—or even a class of structures—is best."); *id.* at 13 ("The way in which corporations . . . control agency costs . . . will change from business to business and from time to time within a firm."); *id.* at 14 ("Just as there is no right amount of paint in a car, there is no right relation among managers, investors, and other corporate participants. . . . To understand corporate law you must understand how the balance of advantage among devices for controlling agency costs differs across firms and shifts from time to time.").

Divergent and changing interests alone do not make contractual solutions unbearably costly. As Easterbrook and Fischel note, creditors' interests also diverge from the firm's and their proper relationship varies over time. For instance, creditors' interests will diverge radically from shareholders' interests if the firm is insolvent or near bankruptcy. *See* STEPHEN A. ROSS ET AL., CORPORATE FINANCE 420-24 (2d ed. 1990). The market solution for this problem is that creditors' "rights and obligations [are] fixed by contract in excruciating detail." CORPORATE LAW, *supra* note 2, at 168. The obvious question is why it is more costly for underwriters and entrepreneurs to negotiate *passivity terms* than it is for bankers and managers to negotiate *loan covenants*? Contracts emerge when the gains to the contract exceed the costs of writing it. If pure passivity is an extremely valuable means of reducing agency costs, there should still be times where pure passivity would emerge by contract. Thus, while it is certainly too costly to specify everything about the relationship between shareholders and managers, Easterbrook and Fischel need to show why it would be too costly to specify a much narrower range of behavior: that is, the response to tender offers.

96. CORPORATE LAW, *supra* note 2, at 166.

C. *Conclusion*

Easterbrook and Fischel are unable to explain why their preferred rule—target passivity—has not arisen by contract. On one hand, they take survival to be an indication of efficiency[97]—surviving contractual provisions are presumptively efficient because they represent the judgments of people betting their fortunes.[98] On the other hand, they inexplicably abandon survival as a criterion for evaluating a board's resistance to takeovers.[99] The conflict between their avowed criteria (contract) and their suggested rule (pure passivity) is never resolved. In response to these difficulties, Easterbrook and Fischel propose making pure passivity a default rule. Although this change is a response to earlier criticisms, they are still unable to justify either the term (passivity) or their claim that it should be mutable.

First, the passivity default fails their own majoritarian requirement for default terms because explicit contracts for target response to tender offers all establish resistance rather than passivity.[100] Thus, to the extent existing contracts are evidence of shareholder preferences, shareholders desire that management be free to mount some resistance. Second, although most charters are incomplete in that they do not fully specify management's duty in response to a tender offer, such charters—absent a showing of incontractability—indicate a desire to allow management the option to resist. Defensive tactics are generally cheaply and quickly adopted when the time comes and must be anticipated by shareholders.[101] Therefore, the fact that passivity is possible but rare "suggests that shareholders' interests coincide with existing legal rules."[102] If the absence of passivity contracts is best understood as agreement that managers should have the option to mount a defense, the efficiency thesis dictates that "[t]here is no

---

97. *Id.* at 33 ("[W]idespread, enduring practices are likely to be beneficial."); *id.* at 37 ("One thing that cannot survive is systematic efforts to fool participants."); *id.* at 48-49 ("[T]he evidence of survival is indeed highly informative.").

98. *Id.* at 19 ("[I]f professional investors with their fortunes on the line are unable to anticipate the true effects of nonvoting stock or some other wrinkle, how are members of state legislatures or other alternative rule givers to do better?"); *id.* at 31 ("The critic who says that some important term of corporate governance has escaped this mechanism is saying either that the costs and benefits are not knowable or that he alone knows the costs and benefits. . . . The more likely hypothesis, however, is that the people who are backing their beliefs with cash are correct; they have every reason to avoid mistakes, while critics (be they academics or regulators) are rewarded for novel rather than accurate beliefs. Market professionals who estimate these things wrongly suffer directly; academics and regulators who estimate wrongly do not pay a similar penalty. Persons who wager with their own money *may* be wrong, but they are less likely to be wrong than are academics and regulators, who are wagering with other people's money.").

99. *See id.* at 5 ("The best structure cannot be derived from theory; it must be developed by experience. We should be skeptical of claims that any one structure—or even a class of structures—is best.").

100. *See supra* text accompanying note 44.

101. *See supra* text accompanying note 45.

102. CORPORATE LAW, *supra* note 2, at 142 (arguing that the absence of contracts providing for alternative division of corporate opportunities is evidence of tacit shareholder consent and, thus, of the law's efficiency).

reason [corporate law] should be used to impose a term that defeats [these] actual bargains. . . ."[103]

Viewed in this light, Easterbrook and Fischel's proposal would have only *trivial* effects. Given that investors appear to have already expressed their preference, a passivity default rule would merely *increase transaction costs*, because investors would contract away from passivity.[104] An argument that a rule of passivity is incontractible or unreasonably expensive has not been made. In short, to the extent that there is empirical evidence of the wishes of most firms, it does not establish that pure passivity is the term to which the majority of firms would contract.[105]

Easterbrook and Fischel not only fail to defend their proposed term, pure passivity, but they also fail to justify making it a default term. Indeed, several of their arguments in defense of passivity suggest that the rule should be *mandatory*, not enabling. For instance, they claim that contracts allowing defensive tactics may be inefficient because they impose costs on bidders and bystanders. The more defenses Firm *A* employs, the less profitable are efforts to monitor. This leads to decreased investment in monitoring, which harms investors in Firm *B*, whose managers are now less threatened with removal. Thus, even consensual defensive devices in Potential Target *A* increase agency costs in Potential Target *B*.[106] Assuming that Easterbrook and Fischel are correct, why should the law ever permit defenses?[107] If, as they assume, the goal of corporate law is to maximize wealth, they should never defer private agreements between parties who do not bear the full marginal cost of their actions. Easterbrook and Fischel would surely object to wealth reducing pollution even if it were consensual as between a plant's owners and managers.[108] Moreover, even if defensive tactics create third party costs, it is not clear pure passivity is the best solution. Easterbrook and Fischel do not address the two standard solutions to the problem of externalities: (1) imposing taxes on defenses or (2) subsidizing search costs. Such measures would be difficult to calculate precisely, but may nevertheless prove more effective.

---

103. *Id.* at 35. In Easterbrook and Fischel's view, corporate law should mimic actual bargains rather than defeat them. Their proposal may thus be understood as "lawmaking in the shadow of bargains," to paraphrase Robert Mnookin and Lewis Kornhauser's famous piece. Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950 (1979).

104. Indeed, for all firms with poison pills and other shark repellents, the current regime is indistinguishable from the regime Easterbrook and Fischel propose.

105. *But cf.* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 93, 108-19 (1989) (suggesting that contract rules picked by the majority of contractors may not always be efficient); Ayres, *supra* note 41 (same).

106. Easterbrook & Fischel, *Proper Role*, *supra* note 23, at 1176-77. This may be one of the situations to which Easterbrook and Fischel refer when they observe that "'contractual' terms for many kinds of problems turn out to be public goods!" CORPORATE LAW, *supra* note 2, at 35.

107. Unfortunately, the nature of these external costs is not fully explored. As others have argued, it seems more likely that firms making credible commitments to passivity would receive careful scrutiny and, thereby, would internalize the benefits of passivity. *See* Haddock et al., *supra* note 27, at 726.

108. CORPORATE LAW, *supra* note 2, at 39 (problems such as pollution are solved by establishing property rights so that the firm treats social costs as private ones).

Thus, it is curious that they accept contractual defenses, only moments after explaining that such defenses have inefficient third party effects. Easterbrook and Fischel do not explain their willingness to retreat from their normative commitment to social wealth by allowing consent to trump efficiency. The book ends with the corporate law paradox unresolved. This failure leaves the passivity thesis absolutely opposed to the efficiency thesis, and yet they nevertheless struggle to maintain passivity by proposing it as a default rule.

Because even their new proposal assumes the efficiency of passivity, Easterbrook and Fischel remain vulnerable to the blistering attack they make on other proposals. Consider their evaluation of the most serious challenger to the passivity thesis—the single-owner standard and the auction rule it suggests:[109]

> It is easy to write the articles of incorporation (or poison pill securities) to facilitate [limited auctions]. . . . According to the single-owner and auctions approach, such a security would be valuable. Yet *no* firm has adopted it—not on going public, not later. Although agency costs are high, many managerial teams are scrupulously dedicated to investors' interests. Why have these managers not employed such devices? By increasing the value of the firm, they would do themselves a favor (most managers' compensation is linked to the stock market, and they own stock too). Nonexistence of securities said to be beneficial to investors is telling.[110]

What is telling for auctions seems at least as telling for passivity.

We have argued that Easterbrook and Fischel's efficiency thesis has not been, and likely cannot be, persuasively reconciled with their passivity thesis. Curiously, Easterbrook and Fischel did not simply abandon their passivity thesis in deference to the contractual evidence against it. By renouncing property rule protection, they could have made a much stronger case for their efficiency thesis. Instead, Easterbrook and Fischel opted to compromise the efficiency thesis for the sake of the passivity thesis. We do not believe that their choice reflects merely an act of loyalty to an old and cherished idea, although this may be the case. More likely, the authors remain persuaded by the force of their own "academic" arguments in favor of passivity, notwithstanding the evidence to the contrary.

Easterbrook and Fischel are by no means the only scholars whose work is threatened by the efficiency thesis. A large group of legal economists maintains

---

109. A strong articulation of this standard can be found in Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982) [hereinafter Bebchuk, *Facilitating Competing Tender Offers*].

110. CORPORATE LAW, *supra* note 2, at 205. Aside from the irony of the statement, the most astounding thing about this passage is its adaptation of poison pills as a standard for efficient and wealth maximizing contracts. *See also id.* at 142 ("Although it should be relatively easy to reach such [corporate opportunity] contracts, they appear to be rare, which suggest that shareholders' interests coincide with existing legal rules.").

that takeover defenses are generally inefficient.[111] Yet, as an empirical matter, such defenses are ubiquitous, and there is no consensus with respect to why the various contractual mechanisms of corporate law have not substantially eliminated them.[112] Thus, when considering the theoretical work of academics attempting to distinguish efficient from inefficient arrangements, the corporate law paradox takes on added dimension. There is an unexplained, fundamental tension between what is and what ought to be. But this paradox may well contain important truths. In Part II, we reopen the debate over what rules should govern target management's response to tender offers. We take a step toward resolving the corporate law paradox by proposing a rule that is responsive to both the theoretical conclusions of academics as to the rules shareholders *should* prefer in contracts and the strong empirical suggestion given by corporate practice as to the rules shareholders *do* prefer.

II. PROPERTY RULES, LIABILITY RULES, AND UNAVAILABILITY: PROTECTING SHAREHOLDERS' RIGHT TO TRANSFER SHARES[113]

Few topics have been more hotly contested in the corporate law literature than the question of how managements should respond to tender offers.[114] As we argue in this Part, this controversy can be understood as a debate over how much, if any, protection should be given to shareholders' entitlement to accept or reject an offer for their shares (the "transfer entitlement").[115] Broadly speaking, there are now two schools of thought.

A. *Property Rule Protection*

The first school, comprising efficiency-minded academics (Easterbrook and Fischel among them), argues that only target shareholders, not target managers, should decide whether a bid for the target is ultimately accepted or rejected.[116]

---

111. *See, e.g.*, authorities cited *infra* note 116.

112. However, Lucian Bebchuk has suggested reasons why charter provisions and state rules may sometimes be inefficient with respect to takeovers. *See generally* Bebchuk, *supra* note 57; Lucian A. Bebchuk, *The Desirable Limits of State Competition for Charters*, 105 HARV. L. REV. 1437 (1992) [hereinafter Bebchuk, *Limits of State Competition*].

113. This Part relies on a conception of legal rules first articulated in Calabresi & Melamed, *supra* note 69.

114. *See* authorities cited *infra* notes 116, 118 & 125.

115. For simplicity, we call the potential opportunity that target shareholders have to sell their shares at a premium an "entitlement." Below we allow for the possibility that the entitlement would receive no protection or, in other words, that there is no entitlement. *See infra* note 128 and accompanying text.

116. The literature has been stimulated in considerable part by Easterbrook and Fischel's early collaborations. *See* Easterbrook & Fischel, *Proper Role*, *supra* note 23; Easterbrook & Fischel, *Corporate Control*, *supra* note 16, Easterbrook & Fischel, *Auctions*, *supra* note 23; *see also* Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982) [hereinafter Bebchuk, *Reply*]; Bebchuk, *Facilitating Competing Tender Offers*, *supra* note 109; Peter Crampton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J. L. ECON. & ORGANIZATION 27 (1991); Ronald J. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the*

Although they have never expressed it in these terms, members of this school are, in effect, proposing that the transfer entitlement be given "property rule protection."[117]

Proponents of property rule protection are motivated primarily by two efficiency concerns.[118] First, they want to ensure that assets are moved to their highest valued use.[119] Second, they want to minimize the agency costs resulting from the corporate condition—that is, the separation of ownership and control.[120] To encourage monitoring of incumbent managements, and thereby to reduce agency costs, property rule proponents are concerned with minimizing the costs of, or maximizing the returns to, the search for potential targets.[121] Much of the debate within the property rule camp is over the possible tension

---

Enabling Concept, 34 STAN. L. REV. 775 (1982) [hereinafter Gilson, *Shark Repellent*]; Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981) [hereinafter Gilson, *Structural Approach*]; Schwartz, *supra* note 25. *See generally* CORPORATE LAW, *supra* note 2, at 209-11 (reviewing financial economics literature).

117. According to Calabresi and Melamed, "an entitlement is protected by a property rule to the extent that someone who wishes to remove the entitlement from the holder must buy it from him in a voluntary transaction in which the value of the entitlement is agreed upon by the seller." Calabresi & Melamed, *supra* note 69, at 1092.

118. Among those advocating property rule protection, Easterbrook and Fischel demarcate one end of the continuum. Under their pure passivity approach, target management could take no action either to resist a bid or to encourage a friendly bidder to join the contest. *See* CORPORATE LAW, *supra* note 2, at 171-74 (calling for a pure passivity rule that is mutable by contract); Easterbrook & Fischel, *Proper Role*, *supra* note 23, at 1164, 1194-1204; *see also* Schwartz, *supra* note 25 (taking similar position). Toward the other end of the continuum are those who agree that managers should not be permitted to defend against a takeover but should be permitted to conduct an auction in order to enhance allocational efficiency. *See* Bebchuk, *Reply*, *supra* note 116, at 24; Easterbrook & Fischel, *Auctions*, *supra* note 23, at 2-3 (explaining that Gilson and Bebchuk agree "that defensive stratagems for the purpose of preserving target's independence . . . reduce investors' wealth"); Ronald J. Gilson, *Seeking Competitive Bids versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51, 52 (1982) [hereinafter Gilson, *Tender Offer Defense*] ("Taken together, our respective articles demonstrate that there is no coherent justification for allowing target management to engage in defensive tactics that may deprive shareholders of the opportunity to tender their shares."). In cases where it is clear that a target board has decided to sell the corporation, Delaware courts have embraced the latter view, holding that auctions are required for the benefit of target shareholders. Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986) (once a sale of the target is inevitable, the role of management changes from "defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company"). One reason why Easterbrook and Fischel have rejected this view is that they believe that allowing managers the ability to hold auctions may mean that shareholders' transfer entitlement receives effectively no protection because managers may actually thwart bids under the guise of holding an auction. CORPORATE LAW, *supra* note 2, at 169 ("[H]ow could we tell whether managers are running an extended auction or simply extending their tenure?"); *see also supra* notes 79-80 and accompanying text.

119. Bebchuk, *Reply*, *supra* note 116, at 39-41; Easterbrook & Fischel, *Auctions*, *supra* note 23, at 13-15; Gilson, *Tender Offer Defense*, *supra* note 118, at 62-64.

120. The classic statement of this concern is ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933). For more recent renditions, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) and, of course, CORPORATE LAW, *supra* note 2, at 1-40.

121. *See infra* Part II(C)(2) (discussing "search").

between those two goals.[122] Except for that tension, members of the property rule camp agree both that target managers should be prohibited from erecting takeover defenses and that shareholders should have final control over whether to accept a tender offer.[123] This agreement about how to protect the transfer entitlement is related to a more general agreement that the stock market accurately values target companies.[124]

B. *No Protection or "Unavailability"*

The second school—including several scholars who reject the economic premises upon which the property protection school is based—takes the position that target shareholders should have virtually no say (or, in other words, that target management should have complete say) in whether a bid is accepted or rejected.[125] Significantly, this full resistance approach has been embraced by the Delaware courts.[126] According to Delaware's "just say no" rule, managers

---

122. Consider the debate over auctions, *see supra* note 118. Proponents of auctions argue that auctions direct assets to their highest valued use with lower transaction costs. Opponents argue that auctions, by increasing the price paid by the acquiror, may reduce the incentive of the first bidder to search for undervalued corporations and thus increase agency costs. For a useful summary of the debate, see Symposium, 35 STAN. L. REV. 1 (1982).

123. *See supra* note 118. The Supreme Court once offered its qualified endorsement of this view in Edgar v. Mite Corp., 487 U.S. 624 (1981):

> The effects of allowing the Illinois Secretary of State to block a nationwide tender offer are substantial. Shareholders are deprived of the opportunity to sell their shares at a premium. The reallocation of economic resources to their highest valued use, a process which can improve efficiency and competition, is hindered. The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced.

Id. at 643 (citing Easterbrook & Fischel, *Proper Role*, *supra* note 23 and Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978)).

124. *See infra* Part II(C)(4).

125. Those scholars who take a law and economics approach all argue in one way or another that resistance can be efficient as a means of overcoming the collective action problem facing shareholders who cannot bargain effectively on their own behalf. *See, e.g.*, William J. Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. B. FOUND. RES. J. 341; Haddock et al., *supra* note 27; Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315 (1987); Dale A. Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court*, 72 CORNELL L. REV. 117 (1986). Others argue in favor of managerial resistance from a non-law-and-economics vantage point. *See, e.g.*, Martin Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. REV. 1231 (1980); Martin Lipton, *Takeover Bids in the Target's Boardroom* 35 BUS. LAW. 101 (1979); Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249 (1983).

126. While the entitlement is technically still protected by the management's duty of care and duty of loyalty, the courts have made it clear that management possesses enormous discretion to defeat tender offers entirely—without the need to compensate shareholders ex post. For instance, Time Inc. shareholders were deprived of an offer to sell at a 100% premium and were never compensated for this loss. Paramount Communications v. Time, 571 A.2d 1140 (Del. 1989). While shareholder vote also protects the entitlement in theory, in practice it is generally of little help as it is often easily avoidable and is hindered by collective action problems. *See also* Panter v. Marshall Field & Co. 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980); Crouse Hinds Co. v. InterNorth, Inc., 634 F.2d 690 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981).

can, with few exceptions, "defend" target shareholders against "inadequate" bids with any number of bid-deterring techniques (e.g., poison pills) so long as the target is not up for sale.[127] It is only a little overstated, therefore, to say that under the current regime protection for the transfer entitlement is *unavailable.*[128]

Proponents of the unavailability approach offer a variety of justifications for their position. Among other things, they are concerned with market inefficiencies[129] and protecting uninformed, and perhaps myopic or irrational, shareholders.[130] If it is true, as proponents of a no-protection rule assume, that target managements are better able to recognize the shareholder-wealth-maximizing option than target shareholders are, then a case can be made for allowing target managements, somewhat paternalistically, to prohibit shareholders from accepting a bid not in their interest.

C. *The Case for Liability Rule Protection*

On one hand, everyone, including the Delaware courts, agrees that target managements have a substantial conflict of interest[131] and that there is an "omnipresent specter that a board may be acting primarily in its own interest" in defending against a takeover, inasmuch as "human nature may incline *even one acting in subjective good faith* to rationalize as right that which is merely personally beneficial."[132] Thus, even the Delaware courts, home of "just say no," seem to recognize that the danger of self-dealing renders the business judgment rule review too permissive. Thus, the current regime under which transfer entitlement protection is virtually unavailable therefore seems to allow too much resistance.

On the other hand, no one disputes that there may be times in which managerial resistance would be in shareholders' best interest ex ante.[133] It is in part for that reason that Delaware courts have been extremely deferential to target managements notwithstanding the high likelihood of management

---

127. *See* CORPORATE LAW, *supra* note 2, at 164-65.

128. Another way of saying that protection of an entitlement is unavailable is just to say that the shareholder has no entitlement and the managers hold the entitlement.

129. *See infra* Parts II(C)(3) and II(C)(4); *see, e.g.,* Lowenstein, *supra* note 125, at 268-309 (arguing that, since the stock market is inefficient, takeovers are unlikely to generate allocative efficiency).

130. Some argue that takeovers are wasteful inasmuch as they distract corporate managers from their more important tasks. *E.g.,* Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors,* 58 U. CHI. L. REV. 187, 188, 201-02 (1991). Some seem to want to protect shareholders from the form of coercion portrayed in the movie, *Heaven Can Wait.* In which the former owner of the Los Angeles Rams complained, "that [bidder] got my team." A sympathetic friend asked, "what kind of pressure did he use, Milt?" The reply was: "Well... I asked for 67 million and he said OK." His friend exclaimed, "Ruthless Bastard!"

131. *See* Revlon Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 179-80 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

132. City Capital Assocs. v. Interco Inc., 551 A.2d 787, 796 (Del. Ch. 1988).

133. Even Easterbrook and Fischel concede as much. *See, e.g.,* CORPORATE LAW, *supra* note 2, at 166.

disloyalty. Property rule protection, which prevents management resistance, has therefore been criticized as allowing too little resistance. Of course, given that some takeovers may be efficient and some may be inefficient, the ideal legal regime would foster the former but screen out the latter. But courts and commentators also seem to agree that courts are incapable of distinguishing loyal from disloyal resistance. The tremendous deference that Delaware courts have given target managements seems based not on confidence in the managements' loyalty but on distrust in judges' ability to distinguish loyal from disloyal managements.[134] As a Delaware court expressed it, there exists a "danger" that "courts—in exercising some element of substantive judgment—will too readily seek to assert the primacy of their own view on a question upon which reasonable, completely disinterested minds might differ."[135] For these reasons, participants on both sides of the entitlement debate have been forced to adopt an all-or-nothing approach.[136]

There is, however, a third, intermediate alternative that neither courts nor commentators have previously considered: namely, liability rule protection.[137] As we shall argue, liability rule protection would disaggregate managerial resistance, preventing disloyal resistance and permitting loyal resistance. Moreover, liability rule protection would satisfy the concerns expressed on both sides of the debate.[138]

---

134. CORPORATE LAW, *supra* note 2, at 98-99; *see also* Panter v. Marshall Field & Co., 646 F.2d 271, 299 (Cudahy, J., dissenting) (emphasizing that the rationale for the business judgment rule is the directors' expertise relative to a court's.).

135. *Interco*, 551 A.2d at 796 (interpreting *Unocal*).

136. *But see* Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247 (1989). To avoid the excesses of either extreme, the Delaware court in *Unocal* sought a middle ground that allowed courts some review over management self-dealing, but left management free to run the firm as it saw fit. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). This standard held out the hope of being able to grant the more pressing concerns of those advocating both rules. Carefully applied, such a standard might have proven an acceptable compromise. However, the promise of *Unocal* has been largely illusory as the more recent decisions have made the standard virtually indistinguishable from the business judgement rule. *See* authorities cited *supra* note 126. *Paramount* ended any possibility that the *Unocal* standard would have substance when it rejected the idea that a court would "substitute its judgement for what is a 'better' deal for that of a corporation's board of directors." Paramount Communications v. Time, 571 A.2d 1140, 1153 (Del. 1989). Thus, the debate over courts' proper role in analyzing the actions of target managements continues, with the participants divided over the ability of courts to monitor management and the propriety of allowing management to monitor themselves. Interestingly, it is the *courts* that continue to insist on their own shortcomings—thus deferring to managers' decisions.

137. *But see* Stephen Fraidin & Peter Golden, *The Value Assurance Plan: A Pill Without Poison*, N.Y. L.J., August 11, 1986, at A1 (describing one target's attempt to guarantee shareholders some of the value of the premium). *See also infra* notes 214 & 242.

138. We are indebted to Professor Ellickson for pointing out that courts and commentators commonly overlook the full range of alternatives in choosing whether to provide an entitlement, to whom the entitlement should be granted, and how the entitlement should be protected. He notes that, given a difficult problem, one potential resolution is to consider granting either of the parties liability rule protection rather than property rule protection or no entitlement at all. *See, e.g.*, Robert C. Ellickson, *Alternatives to Zoning: Covenants, Nuisance Rules, and Fines as Land Use Controls*, 40 U. CHI. L. REV. 681, 719 (1973).

In most contexts, scholars prefer property rule protection because, unlike liability rule protection, it ensures that all transactions are Pareto superior. Calabresi and Melamed write:

According to Calabresi and Melamed, "[w]henever someone may destroy the initial entitlement if he is willing to pay an objectively determined value for it, an entitlement is protected by a liability rule."[139] In this context, liability rule protection would mean that managers could resist a takeover, thereby preventing shareholders from tendering, so long as shareholders were compensated ex post for having to forego a takeover premium. A liability rule approach might take a variety of forms; we suggest just one in the simple model that follows.

> Whenever someone may destroy the initial entitlement if he is willing to pay an objectively determined value for it, an entitlement is protected by a liability rule. This value may be what it is thought the original holder of the entitlement would have sold it for. But the holder's complaint that he would have demanded more will not avail him once the objectively determined value is set. Obviously, liability rules involve an additional stage of state intervention: not only are entitlements protected, but their transfer or destruction is allowed on the basis of a value determined by some organ of the state rather than by the parties themselves.

Calabresi & Melamed, *supra* note 69, at 1092; *see also* WILLIAM LANDES & RICHARD POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 31 (1987) ("When the costs of voluntary market transactions are low, the property approach is economically preferable to the liability ap[p]roach because the market is a more reliable register of values than the legal system. But when the costs of voluntary market transactions are high, the property approach is inferior because it will prevent resources from being shifted to their most valuable uses."); Haddock et al., *supra* note 27, at 707 ("Liability rules cannot ensure the Pareto efficiency of exchanges because subjective values are hard to measure and so may not be fully compensated."). However, this cost of liability rules—that is, the cost of substituting the state for the market—is not the motivating consideration of those who call for property rule protection of shareholders' transfer entitlement. Instead, they are concerned about the target management's conflict of interest. *See supra* notes 131-32 and accompanying text. The traditional justification of property rule protection is thought not to apply in this context because it is assumed that shareholders have homogenous preferences (i.e., the demand curve for the stock is virtually horizontal). Accordingly, the argument goes, the market price *is* the price at which all shareholders are indifferent between buying and selling; hence, liability rule protection comes at no added cost because the shareholders' subjective valuation *can* be objectively ascertained through the market price.

This assumption regarding the homogeneity of shareholder preferences has been the subject of considerable controversy recently. Most significantly, Lynn Stout has argued that takeover premiums may be the consequence of heterogeneous preferences or, in other words, downward-sloping demand. *See generally* Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235 (1990). If Stout is correct, then the traditional justification for providing property rule protection may become relevant. As we argue below, however, our liability rule protection would not contain the drawback that liability rules typically contain. *See infra* notes 143-44 and accompanying text.

139. Calabresi & Melamed, *supra* note 69, at 1092.

1. *The Basic Model*[140]

Let us suppose that at some time, T_1, the stock of a potential acquiree, Target, is trading publicly at some price, P_m, per share and that a potential acquiror, Bidder, makes a tender offer for all of Target's shares with a present value of some amount, P_b, per share. Under our proposed liability rule, Target's management would then decide and publicly announce its position on the bid. If Target's management thought the offer adequate or fair, shareholders would accept or reject Bidder's offer without further interference from management, just as if there were property rule protection. If, in the more relevant scenario, management felt the offer was inadequate or unfair[141] because it was below the firm's "true" value, management could attempt to dissuade shareholders from tendering by informing them, to the extent possible, of why and to what extent Target's "true" value, P_t (that is, the price at which Target's shares would trade were shareholders as informed as management), exceeds the Bidder's offer.[142] As part of that effort, management would be required to announce a time, T_2, at which the present value of Target's shares would equal or exceed P_b per share.

If shareholders are persuaded by management and refuse to tender, then, of course, the tender offer will fail.[143] In the more relevant case, in which shareholders want to tender their shares and management resists, management would be permitted to use any means necessary to avoid being taken over, provided management could make shareholders as well off at T_2 as shareholders

140. In addition to the assumptions noted in the text, our model relies on two assumptions. First, it assumes that stock prices reflect all publicly available information. *See generally* ROSS ET AL., *supra* note 95. Easterbrook and Fischel base their arguments on a similar assumption. CORPORATE LAW, *supra* note 2, at 19-20. We relax that assumption below; *see infra* Part II(C)(4). Second, we assume for simplicity that shareholder preferences are homogeneous such that either all shareholders tender to an offer or none do. Whatever problems that would emerge under our proposed regime are similar in kind and degree to the problems that emerge under the current regime in cases where some, but not all, shareholders tender. *See* DEL. CODE ANN. tit. 8, § 262 (1989) (shareholders who dissent from merger or consolidation entitled to receive fair value of shares); MODEL BUSINESS CORP. ACT § 13.02 (1984) (shareholder who dissents from merger, share exchange, sale of substantially all assets, or amendment to articles which materially and adversely affects dissenter's rights, entitled to fair value of stock). *See generally* CORPORATE LAW, *supra* note 2, at 145-61; Hideki Kanda & Saul Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429 (1985); Joel Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829 (1984).

141. Our primary concern, of course, is with those cases in which Target's management wants to resist a takeover and Target's shareholders want to tender.

142. This is consistent with Easterbrook and Fischel's position. Easterbrook & Fischel, *Proper Role*, *supra* note 23, at 1201 ("Perhaps, too, management should be able to issue a press release urging shareholders to accept or reject the offer."). We explain below why it is not implausible that managers would be both correct that Bidder's offer is inadequate and unable credibly to show shareholders why the bid is inadequate. *See infra* Parts II(C)(3) and II(C)(4).

143. It is not the case that shareholders would always tender. When the managers say the bid is adequate, the shareholders will tender. When the management says the bid is inadequate, however, the case can be complicated. On one hand, if shareholders tender, they are guaranteed a minimum amount, P_b On the other hand, if they tender, they risk losing some of the upside gain, G, (where $G = V - R$, and V is the net present value of Target's new projects) which the management must promise to the bonder. *See infra* note 148 and accompanying text. Thus, management may be able to convince shareholders that they would be better off by not tendering.

would have been had management remained passive.[144] In other words, management may take from shareholders their entitlement to tender to Bidder at T_1, so long as it ensures that shareholders receive the equivalent of P_b at T_2. But how can management possibly pay for, or "bond," its resistance? That question we consider in more detail below.[145] For now, we shall assume a can opener:[146] under a liability rule regime a market would emerge in which loyal (that is, shareholder-wealth-maximizing) resistance would be credibly bonded by third parties ("resistance bonders") but disloyal resistance would not.

It is easy to see why such a market *might* emerge. Suppose that Target's management plans to begin a new project (or set of projects) which has a net present value of some amount, V, but which cannot be revealed to or assimilated by shareholders and thus is not reflected in stock price, P_m.[147] In other words, Target's true value, P_t, equals its market value plus the value of its upcoming project ($P_m + V$). Now, where Bidder bids some amount, P_b, which includes a premium, R, a loyal board would resist in those cases in which $P_t > P_b$ and cooperate when $P_t < P_b$. Because $P_t = P_m + V$, and $P_b = P_m + R$, the point can be restated as follows: A loyal management will resist when $V > R$, and cooperate when $V < R$.

Under these circumstances, resistance creates gains of some amount, G ($G = V - R$) when $V > R$. Third parties would be willing to bond management's resistance, and the Target could afford to pay for such resistance (without lowering P_m) when, but only when, $V > R$.[148]

Having established the decision rule of a loyal management (i.e., resist if and only if $V > R$), we can compare management's response under various legal regimes. Under the current no-protection regime, a disloyal management is able to prevent a takeover even when $R > V$. This thwarts shareholders' interest in maximizing their wealth, and, because the acquisition may not take place even when $P_b > P_t$, it also thwarts the efficiency goal of moving resources to their highest valued use.[149]

---

144. The law could either permit managements to "just say no" to a tender offer or permit them to adopt poison pills and other defenses without any obligation to retract them, provided the managements meet the conditions we specify below.

145. *See infra* Part II(C)(6).

146. For the context of this punch line, *see* A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 1-2 (2d ed. 1989).

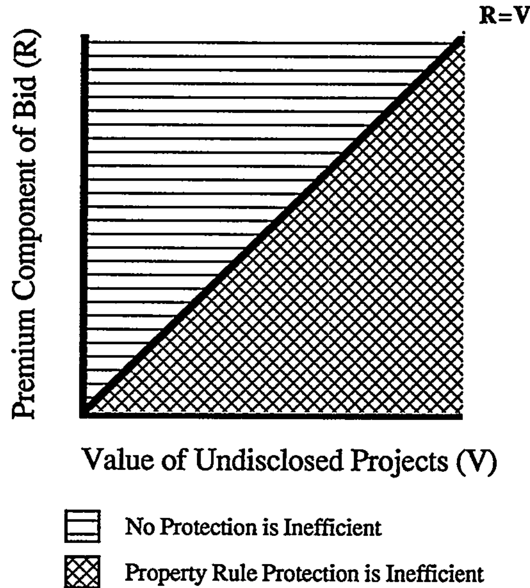
147. We consider below whether, in light of the efficient capital market hypothesis, it is fair to assume that P_t would sometimes exceed P_m (i.e., that $V > 0$). *See infra* Parts II(C)(3) and II(C)(4).

148. We assume here that transactions and contracting costs are zero or, in other words, that bonding occurs whenever $G > 0$. In Part II(C)(6) below, we relax these assumptions and briefly consider the likelihood of a robust market in resistance bonding under a liability rule regime.

149. This assumes, not unrealistically, that P_b represents Bidder's reservation price in cases in which Bidder does not successfully acquire Target. Of course, where Bidder wins Target, efficiency obtains so long as P_b exceeds P_t—which it will, as revealed by the fact that Bidder wins. When Bidder loses, P_b will be Bidder's reservation price because Target management's successful resistance will lead Bidder to increase its bid and, in turn, Target's management to increase its resistance bond until Bidder either wins the contest or gives up the bidding after reaching its reservation price.

Under a regime of property rule protection, such as the one proposed by Easterbrook and Fischel, a loyal management would be unable to resist even when $V > R$. Because shareholders' wealth is not thereby maximized and, in addition, because the acquisition would take place even when $P_t > P_b$, pure passivity is sometimes inefficient. In sum, neither rule will always serve the interests of shareholders or of efficiency.

FIGURE 1: *The Inefficiencies of No Protection and Property Rule Protection*



Under a liability rule approach, however, efficiency would be served in every case. To see this, assume first that Bidder makes a tender offer according to which $R > V$. In those circumstances, a disloyal board may *want* to resist, but will be unable to do so absent third party bonding. Such bonding, recall, will not be forthcoming when $R > V$. Conversely, when $R < V$, management will be able to resist because it will be able to bond its resistance. In sum, under a liability rule approach, managers would be able to resist only when resistance is efficient. Figure 1 depicts the inefficiencies associated with no-protection and property rule protection as compared to liability rule protection.

As we make clear below, the entitlement debate actually envelops a number of more fundamental debates that have broad implications. That is, one's position on the entitlement debate is dictated by one's position on several very important empirical questions, including whether and to what extent the stock market fully reflects all available information. In the following three Subsections, we explore several unanswered empirical questions underlying the entitlement debate and explain how a liability rule renders those questions inapposite, at least with

respect to that debate. Having extolled this significant virtue of a liability rule approach, we argue in Part II(C)(6) that a can opener—that is, a robust market in resistance bonding—may well appear if a liability rule approach were implemented. Finally, we argue that such an approach might actually provide answers to the various empirical questions that have long been at the bottom of the entitlement debate.[150] This notion of using the law as a laboratory is one that legal economists should find appealing. In any case, it provides an additional justification for adopting a liability rule.

2. *Optimizing Search*

Efficiency-minded corporate law scholars agree that the market for corporate control encourages managers to behave loyally.[151] According to most, the price of a company's stock will drop if its management exhibits disloyal behavior. If it drops enough, the company will become an attractive target because the company's market price will be a bargain relative to its potential. Thus, management has a strong incentive to behave loyally in order to avoid becoming a target. This implies that the more robust the market for corporate control, the more loyal corporate managements will be. To encourage managerial loyalty, therefore, several legal economists have proposed means of lowering the size of takeover premiums, which would increase the returns to—and investments in—target search and, in turn, decrease agency costs.[152] Those who accept this characterization of the market for corporate control believe that virtually all of the gains from the tender offer should be allocated to reward bidder search.

On the other hand, it has also been argued that the market for corporate control, while indeed lowering agency costs, acts more as a carrot than a stick. To the extent that shareholders know they will be able to resist a takeover attempt in the future and thus extract a relatively large portion of the gains from trade, they will have a greater incentive to make value maximizing investments in the corporation.[153] With respect to investments in *search*, potential targets arguably can locate an appropriate bidder at less cost than a potential bidder can locate appropriate targets. A target's ability to extract some significant

150. *See infra* Part II(C)(7).

151. *See, e.g.*, CORPORATE LAW, *supra* note 2, at 163-209; Michael C. Jensen, *Active Investors, LBO's, and the Privatization of Bankruptcy*, 2 J. APPLIED CORP. FIN. 2, 35-44 (1989) (estimating the accumulated losses from mismanagement from 1975 to 1986 exceed $400 billion); Alfred Rappaport, *The Staying Power of the Public Corporation*, HARV. BUS. REV., Jan.-Feb. 1990, at 68, 100 ("[I]t is impossible to overstate how deeply the market for corporate control changed the attitudes and practices of U.S. managers. . . . It represents the most effective check on management autonomy ever devised. And it is breathing new life into the public corporation.").

152. *See, e.g.*, Easterbrook & Fischel, *Proper Role*, *supra* note 23 at 1178; Schwartz, *supra* note 25. We have noted several problems with this viewpoint above. *See supra* Part I(B) (explaining, among other things, that the benefits of lowering search costs can be internalized via contract); *see also supra* notes 118 & 122 (describing the debate over the efficiency of auctions).

153. *See* Bebchuk, *Reply*, *supra* note 116, at 39-43; Haddock et al., *supra* note 27, at 706-19. *See generally* Bebchuk, *Facilitating Competing Tender Offers*, *supra* note 109, at 1041-46.

portion of the gains from trade gives potential targets an incentive to engage in precisely that kind of search.[154]

One's analysis of whether the market for corporate control functions more as a carrot or as a stick will dictate one's prescription for protecting shareholder tender rights. Those who adhere to the "stick" view want to replace the current no-protection regime with a property protection regime.[155] Those who see the corporate control market as a "carrot" argue that some or all of the current, no-protection regime should be preserved.[156] Thus the "search" argument can cut both ways—supporting either resistance or passivity, depending on whether one thinks targets or bidders are the least-cost searchers.[157]

Our proposal is unique in allowing the market for corporate control to serve as a source of both managerial discipline and reward. Under liability rule protection, target managements would be displaced whenever $R > V$; bidders would have to pay no more than the target's true value. A potential bidder would have optimal incentives, therefore, to search for any firms that would be more valuable in the bidder's hands than in current management's hands. Further search would be inefficient.[158] The market will thus discipline inefficient and inept managements. Also, since target shareholders would always receive at least P_t for their shares, liability rule protection will ensure that shareholders and managers are appropriately rewarded for both their short run and long run investments in increasing the target's value.[159]

3. *The Implications of Private Information on Publicly Traded Stock*

For the past decade, corporate law scholarship has been dominated by scholars who accept, by and large, the semi-strong version of the Efficient Capital Market Hypothesis (ECMH). The ECMH posits that all publicly available

154. *See, e.g.*, Bebchuk, *Reply*, *supra* note 116, at 38-39; Haddock et al., *supra* note 27, at 737-42.

155. *See* authorities cited *supra* note 118.

156. *See* authorities cited *supra* notes 125 & 154.

157. *Cf.* Bebchuk, *Reply*, *supra* note 116, at 43-44 ("To induce the optimal level of search, they say, searchers should capture the social value of their activity. The same logic suggests that to induce optimal levels of capital investment, shareholders should be provided with the social gains resulting from their investment.").

158. It may be true that there would be more search under Easterbrook and Fischel's rule of pure passivity than under our proposed liability rule and that Easterbrook and Fischel would not agree that their rule leads to inefficiently high levels of search. But the apparent disagreement about which rule would yield the most efficient level of search is not over what type of search is inefficient but rather over the extent to which stock market prices reflect a corporation's true value. Easterbrook and Fischel believe that market price provides the best measure of value. *See infra* text accompanying note 166 and accompanying text. If they are correct, then the same amount of search would occur under our proposed regime as would occur under theirs because any bid that includes a takeover premium under our regime would be irresistible (resistance bonding would be unavailable). If, however, stock price sometimes understates a corporation's true value, then Easterbrook and Fischel's regime would lead to inefficiently high levels of search while ours would lead to efficient levels.

159. There is still a question of how much of the buyer's surplus Target's shareholders should be able to extract. We need not address that issue, however, inasmuch as our proposal permits us to be agnostic regarding the role of auctions.

information about a firm will be fully reflected in its stock price.[160] But even assuming semi-strong-form efficiency,[161] there remains a class of information that stock prices will not fully reflect—namely, nonpublic information.[162]

Where Target's management has nonpublic information regarding projects that will enhance its value, Target's stock price (P_m) will not fully reflect Target's true value (P_t). Where $P_t > P_m$, that implies that $V > 0$, which, in turn, implies that if Target's management cannot resist, Target's assets may be transferred to a lower valuing user (i.e., where $V > R$). Thus, built into the ECMH is the possibility for inefficient transfer ($P_m < P_b < P_t$).[163] Some corporate law scholars argue that this potential source of inefficiency justifies target resistance.[164] Others claim that the potential inefficiency, while theoretically plausible, has not been observed and, therefore, is an unsound foundation for policy prescriptions.[165]

Easterbrook and Fischel take the latter position. They assert that in cases in which Target's management has inside information, disclosure would preempt the tender offer:

> We can conclude . . . , with some confidence, that a tender offer at a price higher than the prevailing one also exceeds the value of the stock. True, the target's managers may know something about the firm's prospects not yet incorporated into the price of the shares. But the disparity between price and worth could not last long. If a bidder tried to steal the target by capitalizing on its special information, the target's managers could defeat the offer by disclosing the information to the public. The price would adjust to reflect the new information, and the offer would succeed only if it were higher than the new price. Tender offers at a premium thus must benefit the target's shareholders.[166]

160. Schwartz, *supra* note 25, at 241. *See generally* ROSS ET AL., *supra* note 95, at 338-54; Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 554-56 (1984) (describing different forms of efficiency and their origins). Another version is "strong-form" efficiency, which posits that all public and nonpublic information is quickly and fully reflected in the security's price. The evidence, however, suggests that market prices do not fully reflect nonpublic information. *See, e.g.*, Daniel W. Collins, *SEC Product Line Reporting and Market Efficiency*, 2 J. FIN. ECON. 125 (1975) (market did not assimilate nonpublic information about sales and profits); James H. Lorie & Victor Neiderhoffer, *Predictive and Statistical Properties of Insider Trading*, 11 J. L. & ECON. 35, 47 (1968) (actual insider trading yielded above-normal profits); James M. Patell, *Corporate Forecasts of Earnings per Share and Stock Price Behavior: Empirical Tests*, 14 J. ACCT. RES. 246, 273-75 (1976) (market did not assimilate nonpublic managerial forecasts). Unless otherwise indicated, we shall refer to the semi-strong version of the ECMH simply as "the ECMH." *See infra* text accompanying notes 175-91 (providing a brief history of the ECMH in legal literature).

161. In Part II(C)(4), *infra*, we relax that assumption.

162. CORPORATE LAW, *supra* note 2, at 115-16. Haddock et al., *supra* note 27, at 717; Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 979, 988-89 (1992).

163. *See* Kahan, *supra* note 162, at 987-1005; *see also* Schwartz, *supra* note 25, at 241 ("In this circumstance, a takeover is inefficient. The acquiror could produce no more wealth than the target's managers would, but the costs associated with the takeover—search, bidding expenses—are a dead-weight loss.").

164. *See, e.g.*, Bebchuk, *Reply*, *supra* note 116, at 34; Haddock et al., *supra* note 27, at 717.

165. *See, e.g.*, Schwartz, *supra* note 25, at 241.

166. Easterbrook & Fischel, *Proper Role*, *supra* note 23, at 1167-68; *see also* Kahan, *supra* note 162, at 1035-38.

Thus, according to Easterbrook and Fischel, if target management does not reveal information regarding V, or if it does disclose that information but shareholders tender anyway, then $P_b > P_t$. Where a tender offer is successful, it must be efficient.

But Easterbrook and Fischel's response to the problem of nonpublic information is incomplete. First, it ignores the possibility that the value of information can be destroyed by making it public.[167] Second, information regarding a firm's projects is very costly for shareholders to acquire because in the tender offer context, there is little time or opportunity for management to publish the relevant information.[168] Moreover, the sort of information they can publish is limited by regulations and the threat of liability.[169] Shareholders will have difficulty processing the information about future projects because it is typically "soft" rather than "hard" information—that is, "information of forecasts and estimates" rather than "information of known facts."[170] Finally, not only would shareholders be hard pressed to verify the information they received, but shareholders would have strong reason to doubt its veracity. That is true especially in light of Easterbrook and Fischel's well-known and widely repeated view that target managers tend to behave disloyally.[171] As Professors Gilson and Kraakman argue in their famous review of the mechanisms of market efficiency, the higher the costs of acquiring, processing, and verifying information, other things being equal, the less efficient the stock market is likely

167. The obvious example is a case where a firm may have discovered a valuable asset, such as mineral deposits, and may be in confidential negotiations to exploit the opportunity. In this case, revealing the information to competitors may destroy its value. *See* CORPORATE LAW, *supra* note 2, at 319 (management "may choose not to disclose certain things at all because they fear that disclosure could tip off rivals to ongoing developments"); *id.* at 292-93 (assuming that firms cannot disclose the details of some projects); Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CINN. L. REV. 347, 354 (1991) ("[C]ompetitive factors [may] constrain management's ability to disclose information affecting the value of the firm."); Schwartz, *supra* note 25, at 241 n.20 (conceding this possibility but denying that it is a major cause of takeovers). There appear to be real examples of similar takeovers. *See* Haddock et al., *supra* note 27, at 717 n.34 (describing one hostile takeover by Sir James Goldsmith).

168. Tender offers must be kept open at least twenty business days. Beyond that, there can be significant time pressures on target shareholders. *See* CLARK, *supra* note 11, at 546-47, 551.

169. *See* Louis P. Friedman, Note, *Defensive Stock Repurchase Programs: Tender Offers in Need of Regulation*, 38 STAN. L. REV. 535, 566 n.102 (1986) (citing relevant case law and concluding: "[T]he directors' potential liability for disclosing this type of information is so great (if actual outcomes substantially differ from the 'soft' estimates) that they will probably refuse to reveal their internal projections."); *see also* Kenneth M. Tallering, Note, *Target Corporation Disclosure of Soft Information in Tender Offer Contests*, 54 FORDHAM L. REV. 825 (1986) (describing the complexity of target disclosure requirements under the antifraud provisions of the Williams Act and the Securities Exchange Act of 1934).

170. *See* Gilson & Kraakman, *supra* note 160, at 561-62.

171. Note, further, that a shareholder's decision regarding whether to tender is analogous to the decision about whether to vote for or against a shareholder initiative. Easterbrook and Fischel have faith in shareholders to make an informed decision in the former situation, while recognizing that shareholders appear not to make informed decisions in the latter case, because of information costs and the problem of "rational passivity." *See* CORPORATE LAW, *supra* note 2, at 197, 286-90, & ch.3 (describing the information cost and free-rider problems undermining the efficacy of voting mechanisms). The tendency of target shareholders to simply accept the premium—a bird in the hand—may well overwhelm management's unverifiable claim that there are two in the bush. *Cf.* Gordon, *supra* note 167, at 355.

to be.[172] Thus, even were it correct that nonpublic information might be made public in the context of a tender offer, that does not necessarily lead to the conclusion that market price would accurately reflect the value of that information.[173]

In any case, scholars have taken opposing views on the significance of this one exception to the ECMH—nonpublic information—as a justification for managerial resistance to tender offers. Some believe the problem is significant and that legal rules should attempt to minimize it, while other disagree on both counts. Opposing sides are at loggerheads, for their positions are based on empirical hunches that seem untestable.[174]

A liability rule, however, would eliminate any need to resolve the dispute. Those who believe that unrevealable nonpublic information is empirically significant should be satisfied with a liability rule regime in which managements are able to resist when the value of the nonpublic information exceeds the premium ($V > R$). Those who, like Easterbrook and Fischel, believe that unrevealable nonpublic information rarely, if ever, justifies resistance should likewise be satisfied that resistance would rarely, if ever, occur in a liability rule regime.

4. *Are Capital Markets Fundamentally Efficient?*

A second, more fundamental debate regarding the efficiency of the stock market has recently arisen. To understand that debate, it may be helpful to review the information gap between financial and legal economics. In 1978, Michael Jensen, a financial economist, remarked that "there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis."[175] While the ECMH may have been well accepted in the financial literature, it had, by that time, received very little attention in the legal literature. When, in the late 1970's and early 1980's, Easterbrook and Fischel rode into town on the back of their pure passivity thesis, they were among the first legal scholars to brandish the ECMH. Their articles helped to bridge the gulf that had long existed between financial and legal economics.[176] Largely because of Easterbrook and Fischel's academic

---

172. *See generally* Gilson & Kraakman, *supra* note 160.

173. *Cf.* David W. Leebron, *Games Corporations Play: A Theory of Tender Offers*, 61 N.Y.U. L. REV. 153, 171-74 (1986).

174. Event studies of the share prices of targets of failed bids do provide some insight and suggest that the proportion of takeovers motivated by inside information may not be high. *See* Roberta Romano, *Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 143-44 (1991). Nevertheless, others dispute this interpretation, saying that the studies are consistent with the existence of a problem. *See infra* note 207 and accompanying text.

175. Michael C. Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 95 (1978).

176. *See* Gilson & Kraakman, *supra* note 160, at 549 & n.1; Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited* 140 U. PA. L. REV. 851, 853 & n.9

arbitrage,[177] the ECMH made a "remarkably quick transition from theory into [legal] doctrine."[178] Indeed, the transition was so rapid and so complete that, in 1984, Professors Gilson and Kraakman opened their own gulf bridging article with the following summary:

> Of all recent developments in financial economics, the efficient capital market hypothesis . . . has achieved the widest acceptance by the legal culture. It now commonly informs the academic literature on a variety of topics; it is addressed by major law school textbooks on business law; it structures debate over the future of securities regulation both within and without the Securities and Exchange Commission; it has served as the intellectual premise for major revision of the disclosure system administered by the Commission; and it has even begun to influence judicial decisions and the actual practice of law. In short, the ECMH is now *the* context in which serious discussion of the regulation of financial markets takes place.[179]

Gilson and Kraakman's article provided the only general explanation for "what makes the market efficient."[180] With that addition, 1984 may well have been the high water mark of the ECMH in the legal literature.

Beginning in the mid-1980's, doubts regarding the ECMH emerged first in the financial economics literature, and then began to trickle into the legal literature.[181] But what began as a trickle has more recently become a deluge.[182] Legal scholars familiar with current financial economics literature agree that there is now reason to doubt the efficiency of markets. Professors Macey, Miller, Mitchell and Netter summarize the current research as follows: "[W]e can at a minimum conclude that substantial disagreement exists among financial economists about what conclusions empirical tests of market efficiency

---

(1992); *see also* Easterbrook & Fischel, *Corporate Control Transactions*, *supra* note 16 (applying the ECMH to freezeouts and other instances in the context of corporate control transactions when shareholders received unequal treatment); Easterbrook, *Insider Trading, Secret Agents*, *supra* note 14, at 335-37 (describing how insider trading may make the market more efficient); Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX L. REV. 1, 3 (1978) (arguing, in what would be the precursor to the passivity thesis, that the ECMH "undermines the supposed justification for current tender offer regulation and legal defensive tactics available to target company management").

177. Easterbrook and Fischel's most important collaborations were almost all published by 1982. *See supra* note 23 (citing Easterbrook & Fischel's articles).

178. Langevoort, *supra* note 176, at 853.

179. Gilson & Kraakman, *supra* note 160, at 549-50 (citations omitted).

180. *Id.* at 551.

181. *See, e.g.*, Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 825 (1985) ("This implication—that marketplace capitalization best reflects the value of the firm—is not required by, and may even be inconsistent with, the efficient market hypothesis and the associated finance paradigm. . . . Thus there is no basis for the assertion that prices prevailing in the stock market measure value of a firm to a potential acquiror."); William K. S. Wang, *Some Arguments that the Stock Market Is Not Efficient*, 19 U.C. DAVIS L. REV. 341, 363-75 (1986).

182. For a useful review of this latest trend, see Langevoort, *supra* note 176, at 853-72.

support."[183] Indeed, "substantial disagreement exists about to what degree markets are efficient, how to test for efficiency, and even the definition of efficiency."[184] Similarly, Professor Langevoort concludes from his review of the current financial economics literature that "what is important for present purposes seems beyond debate: strong claims of efficiency are debatable."[185]

To understand the source of the new doubts, it is helpful to recognize that the ECMH makes *two* general efficiency claims—namely, that the stock market is both informationally efficient and fundamentally efficient: The market is "informationally efficient" if all public information is immediately incorporated into the stock price; it is "fundamentally efficient" if stock prices accurately reflect only information relating to the net present value of the corporation's future profits.[186] A growing body of work in financial economics now suggests, first, that informational efficiency—for which there *is* substantial empirical support[187]—does not imply fundamental efficiency, and, second, that both the empirical and theoretical bases for the belief that markets are fundamentally efficient are suspect.[188]

Thus, the legal literature now contains two general views regarding the efficiency of the stock market. There are those who, having embraced the ECMH in the early 1980's, remain faithful[189] and those who, in light of recent evidence and theory, are skeptical. Easterbrook and Fischel are among the declining, but still significant, class of true believers.[190] Market skeptics have

183. Jonathan R. Macey et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of* Basic v. Levinson, 77 VA. L. REV. 1017, 1025 (1991).

184. *Id.* at 1018.

185. Langevoort, *supra* note 176, at 856.

186. Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 946-47 (1991) (explaining the distinction between the stronger claim that capital markets are "fundamental-valuation" or "allocatively" efficient and the weaker claim that markets are "informationally" or "speculatively" efficient); *see also* Gordon & Kornhauser, *supra* note 181, at 761, 825-30 (1985); Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891 (1988); Lynn Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 615 n.1 (1988); *id.* at 616 n.11 (describing the ECMH view that "we can rely on market price as a measure of 'true worth' or 'intrinsic value'"); Wang, *supra* note 181, at 344-49 (1986).

187. *See* Macey et al., *supra* note 183, at 1026 ("Financial economists have shown repeatedly that stock prices react quickly to the release of important new information; though they may differ in their interpretations of this evidence, they do agree it exists."). *But see Tilting at Chaos*, ECONOMIST, August 15, 1992, at 70 (describing applications of chaos theory that presumes market inefficiency).

188. *See* Langevoort, *supra* note 176, at 857 ("[M]uch of the recent revisionism in the finance literature criticizes only the rationality of stock prices. Speed of adjustment (at least with respect to certain types of information) and the absence of profitable trading strategies remain useful working assumptions."); Stout, *supra* note 186, at 618 (finding that "the connection between prices in the public trading markets for stocks and the allocation of real resources is a weak one, and that stock markets may have far less allocative importance than has generally been assumed"); *see also* Robert J. Schiller, *Fashions, Fads and Bubbles in Financial Markets*, in KNIGHTS, RAIDERS, AND TARGETS 56-68 (John C. Coffee et al. eds., 1987); Lawrence H. Summers, *Does the Stock Market Rationally Reflect Fundamental Values?*, 41 J. FIN. 591 (1986).

189. *See* CORPORATE LAW, *supra* note 2, at 18-20; Schwartz, *supra* note 25.

190. Easterbrook and Fischel have modified their position slightly and now concede that the market is not *perfectly* efficient. Still, they maintain that the market is superior to either courts or regulators at valuing a firm. CORPORATE LAW, *supra* note 2, at 20. Significantly, however, Easterbrook and Fischel do not contend that the stock market is better informed of a firm's value than the firm's management is. Indeed, they seem

only begun to explore the policy implications of stock market prices that are not always fundamentally efficient.[191]

If the true believers are correct that the stock market is efficient, then the case seems strong for adopting property rule protection of shareholders' transfer entitlements in order to loosen the reins on the corporate control market.[192] However, to the extent that the market is not fundamentally efficient, as some financial and legal economists are now arguing (and as Delaware courts appear to believe[193]), the argument that the corporate control market lowers agency costs may be undermined.[194] The problem with the takeover market, in the words of Professor Kahan, a market skeptic, is that "[a] stock price below fundamental value may lead a raider to commence a hostile takeover . . . even if the transaction does not increase the fundamental value of the company."[195]

These conflicting views pose a difficult policy dilemma for courts because the debate over the efficiency of the stock market is unlikely to be soon resolved. In the face of this dilemma, courts and commentators have implicitly assumed

---

to recognize that the stock market will sometimes be less informed. *See, e.g., id.* at 292-93. *Cf.* Lorie & Neiderhoffer, *supra* note 160 (providing evidence that insider trading yields above-normal profits). Thus, the modified endorsement of the stock market undermines the case for passivity, which assumes that a takeover premium represents a real (not merely nominal) increase in the wealth of target shareholders. Inasmuch as they have maintained their allegiance to the passivity hypothesis, it is fair to characterize Easterbrook and Fischel as "true believers." Our proposal is not inconsistent with this view of the stock market.

191. There continues to be, as indicated above, a significant time lag between the financial economics literature and the legal economics literature. But even the legal literature now contains a growing body of work critical of ECMH. For critiques of the empirical studies supposedly confirming the semi-strong version of ECMH, see MERRITT B. FOX, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY 47-55 (1987); Gordon & Kornhauser, *supra* note 181, at 782-86, 838-41; Wang, supra note 181, at 341, 363-75.

For theoretical critiques of ECMH in the legal literature, see Langevoort, *supra* note 176; Lowenstein, *supra* note 125, at 751-54 (arguing that the market price of stock prior to the announcement of a tender offer is not an accurate measure of the value of the corporation in a control transaction); Stout, *supra* note 138 (questioning the "horizontal demand" hypothesis upon which ECMH depends).

Very recently, legal economists have come to consider the implications of an allocatively inefficient stock market. *See, e.g.*, Ayres, *supra* note 186, at 997; Kahan, *supra*, note 162; Kraakman, *supra* note 186; Langevoort, *supra* note 176; Macey et al., *supra* note 183, at 1049; James R. Repetti, *Management Buyouts, Efficient Markets, Fair Value, and Soft Information*, 67 N.C. L. REV. 121 (1988); Stout, *supra* note 186.

192. It is no accident that the same scholars calling for passivity also maintain a belief in the ECMH. CORPORATE LAW, *supra* note 2; Sanford J. Grossman & Oliver D. Hart, *The Allocational Role of Takeover Bids in Situations of Asymmetric Information*, 36 J. FIN. 253 (1981); Sanford J. Grossman & Oliver D. Hart, *Disclosure Laws and Takeover Bids*, 35 J. FIN. 323 (1980); Schwartz, *supra* note 25; *see also* Gordon & Kornhauser, *supra* note 181, at 824 (describing the connection between the two ideas).

193. *See, e.g.*, Paramount Communications v. Time, 571 A.2d 1140 (Del. 1989). Note that, consistent with the economics literature, courts appear to have greater faith in informational efficiency, *see, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 245-47 (1988) (in efficient market where prices quickly incorporate all available relevant information, market price is best estimate of actual worth, and we can rely on market prices as accurate "indices of real value"), than they do in allocative efficiency. Our proposal should appeal to all those, including courts, who have doubts about the allocative efficiency of the public stock markets. It should be particularly appealing to Delaware courts, which have tried to balance a desire to avoid making business decisions with a wish to mitigate the risk of disloyal target management behavior in the takeover context.

194. *See* Kahan, *supra* note 162, at 1035-37; F. M. Scherer, *Corporate Takeovers: The Efficiency Arguments* 2 J. ECON. PERSPECTIVES 69, 80-81 (1988).

195. Kahan, *supra* note 162, at 1036 (footnote omitted); *see Paramount*, 571 A.2d; Macey et. al., *supra* note 183, at 1025-26 ("The inquiry into efficiency is too complex to warrant its use as the basis for a presumption of reliance on the integrity of the market price of a security.").

that a no-protection approach and a property rule approach are the only two alternatives.[196] As we have already explained, however, if the target's true value exceeds its market value ($P_t > P_m$), then liability rule protection of shareholders' transfer entitlement will protect against the target's assets being moved to lower valued uses. Thus, scholars and courts who do not subscribe to the ECMH should not assume that their policy choice is between all or nothing, between a robust or impotent takeover market, between maximizing the number of value increasing takeovers or minimizing the number of value decreasing takeovers, between, in other words, property rule protection and no protection. Because a liability rule would prevent only those takeovers motivated by the market's temporary inefficient undervaluation, it would weed out inefficient takeovers while cultivating the balance.

Likewise, the true believers—who, not coincidentally, call for passivity[197]—should also embrace a liability rule approach. After all, if the market is indeed efficient at all times, then a liability rule regime is, *de facto*, a pure passivity regime. Although managers may *want* to resist under a liability rule, tender offers will prove irresistible. Given that courts appear unlikely ever to move to pure passivity, true believers should see a liability rule as a pragmatic means to their otherwise unobtainable end.

5. *Lawmaking in Uncertainty*

We have outlined a number of subdebates and their implications for the transfer entitlement debate. Each of these subdebates turns on difficult and unanswered empirical questions.[198] Consequently, the entitlement debate itself seems at an impasse. The major participants, including Delaware courts, appear resigned to the idea that policymakers must make legal rules despite fundamental empirical uncertainty and despite the fact that the current proposals would be efficient only in limited circumstances. Easterbrook and Fischel, for example, conclude their 1982 defense of pure passivity as follows: "Although we have not *proved* that a [pure passivity] rule maximizes the wealth of investors and society, we think the case strong . . . . A definitive answer must await more research, but this is always the case; courts and legislatures must act on the basis of the best available data."[199]

196. *See, e.g., Paramount,* 571 A.2d at 1149-50; Crampton & Schwartz, *supra* note 116; Scherer, *supra* note 194, at 80 (focusing on the net effects rather than the case-specific effects of takeovers: "If takeovers *on average* do little to improve corporations' operating efficiency . . . the case for slowing down what is clearly a costly and disruptive corporate restructuring process gains plausibility.").

197. *See supra* note 192.

198. *See supra* Part II(C)(2) (describing empirical uncertainty over whether bidders or targets are the least-cost searchers); Part II(C)(3) (outlining empirical questions regarding importance of private information); and Part II(C)(4) (explaining empirical and theoretical debate over the stock market's fundamental efficiency).

199. Easterbrook & Fischel, *Auctions, supra* note 23, at 21.

Professor Gilson, having reached somewhat different policy conclusions, seems similarly frustrated by the absence of dispositive empirical data. He writes:

> I have argued that, on balance, allowing target management to solicit competing bids *may* increase rather than decrease return on investment in search, and that such a rule *will* increase allocative efficiency. But I have not *proved* that this rule is preferable, and Professors Easterbrook and Fischel acknowledge that they have not *proved* the superiority of a pure passivity rule. We are, rather, in the world of policymaking, where choices are characterized by uncertainty, and where we are comforted by such empirical evidence as is available and are aided by such theory as we can manage. The major benefit of this exchange has been to clarify the basis for our difference so that those who really are charged with policymaking can do so with a better sense of the competing considerations and the assumptions on which those considerations are based. Indeed, if the exchange has accomplished nothing else, it has identified the character of the research needed to resolve this difference. The research must focus on as yet unanswered empirical questions concerning transactional patterns and costs, questions which become critical when theory is superimposed on reality.[200]

Thus, although the entitlement debate continues, there is a consensus on two related issues. First, policymakers are on the horns of a dilemma and must chose between a regime of property rule protection and a regime of no protection—each of which would be efficient only under limited circumstances. (See Table 2.) Second, more research is needed to resolve the dilemma.

Roughly a decade has passed since the entitlement debate peaked and then stalled, leading the participants to make a concerted plea for empirical research. To date, the appeal has yielded little that would help policymakers choose between the competing hypotheses.[201] The fundamental empirical questions are as up for grabs today as they were before corporate law academics "identified the character of the research needed" in the early 1980's. Indeed, if anything, the debate has been rendered *more* complicated by relatively recent evidence undermining the once rock solid assumption of capital market efficiency.

200. Gilson, *supra* note 118, at 66; *see also* Bebchuk, *Reply*, *supra* note 116, at 49-50 ("I already admitted in my earlier article that no conclusive proof can be offered that the positive effects of competition among acquirors outweigh its possibly adverse effect on the number of acquisitions. Easterbrook, Fischel, and Gilson share this skepticism about the availability of conclusive proof. As Easterbrook and Fischel note, however, legislatures and courts must act on the basis of the best judgments they can form. In my view, both theoretical analysis and the empirical evidence strongly suggest that competition among acquirors is desirable to both society and target shareholders." (citations omitted)); Haddock et al., *supra* note 27, at 703 ("[T]he wisdom of the Easterbrook and Fischel proposal as such hinges on several uninvestigated premises.").

201. This lack of response may be partially due to the fact that rational law professors respond to institutional disincentives to conduct empirical research. *See* Peter Shuck, *Why Don't Law Professors Do More Empirical Research?*, 39 J. LEGAL EDUC. 323, 330-33 (1989).

Absent solid evidence, courts and commentators have chosen legal rules based on intuitions about underlying empirical conditions.[202] Easterbrook and Fischel criticize this undisciplined approach, pointing out that the views of judges and academics are unlikely to be informed or appropriately motivated. A judge or an academic, after all, rarely puts her money where her mouth is.[203] For more certain proof, Easterbrook and Fischel turn to event studies of the average net price effects of successful and failed tender offers.[204] They conclude that these studies prove that "[h]ostile tender offers are responses to the failures of the target's managers, who might be missing business opportunities, including profitable opportunities to merge."[205] This conclusion leads them to recommend that shareholders' rights to transfer their shares to bidders should be protected by a property rule.

While few would question the empirical evidence on which Easterbrook and Fischel rely, some dispute their interpretation and argue that the evidence sheds little light on the pertinent debates. As one scholar recently remarked, "for a variety of reasons, there are various gaps in the chain of logic leading from observed stock price increases to the inference that economic efficiency

---

202. *Cf.* Crampton & Schwartz, *supra* note 116 (recommending various auction rules depending on one's factual assumptions).

203. *But cf.* JOHN KENNETH GALBRAITH, A TENURED PROFESSOR (1990) (providing a fictional counterexample).

204. *See* CORPORATE LAW, *supra* note 2; at 193-98; *see also* Easterbrook & Fischel, *Auctions*, *supra* note 23, at 61 ("[W]e find the data to be compelling evidence that there are real gains to trade involved in almost all offers."). According to Easterbrook and Fischel, tender offers "have become the most studied economic phenomena of the century" because they "leave visible trails in the market." CORPORATE LAW, *supra* note 2 at 193; *see also* Scherer, *supra* note 194, at 70 (event studies have become "the economics and corporate finance profession's closest analogue to the automated factory").

205. CORPORATE LAW, *supra* note 2, at 171. The evidence they rely on is summarized as follows: successful bidders pay target shareholders an average premium (relative to pre-offer price) of 50% for the acquired shares, and unacquired shares trade at an average premium of 30%. *Id.* at 194. Unsuccessful bids are sometimes followed by successful bids and sometimes not. In the latter case, price increases following the announcement of the initial bid eventually dissipate to pre-announcement levels. *Id.* at 195. Successful bidders enjoy positive but small returns on average. The combined returns (those of the target plus those of the bidder) average around 7% to 8%. *Id.* at 196. *See generally* Roberta Romano, *A Guide To Takeovers*, *supra* note 174 (helpfully summarizing the empirical evidence on takeovers).

Easterbrook and Fischel also review the stock price effects of various defensive mechanisms and conclude:

> *Every* device giving managers the power to delay or prevent an acquisition makes shareholders worse off. And although each of these effects looks small (they range from a fraction of a percent to 3 percent), these add up. A percent here, a percent there—that's a lot of money when the base is many trillions of dollars!

CORPORATE LAW, *supra* note 2, at 204. This may be overstated, given that some of the negative price effects on which they rely may not be statistically significant. *Id.* at 195. Moreover, they earlier argued, when summarizing the data on tender offers, that "differences of a few percentage points . . . are trivial under the circumstances." *Id.* at 194. Finally, if defensive devices are indeed so costly, why do shareholders consistently fail to vote against them or to vote out the managers who adopt them? Though it might be costly to become informed of the effects of, say, a fair-price rule in any single instance, it seems likely that, inasmuch as such provisions are not uncommon and because individual shareholders are likely to reencounter them many times, shareholders would find it worthwhile to vote against such amendments in every case. *Cf.* Alan Schwartz & Louis G. Wilde, *Imperfect Information in Markets for Contract Terms: the Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983).

is improved."[206] Although this is not the place to review the complex criticisms of event study methodology, several points are worth noting. First, event studies do not resolve the various subdebates inasmuch as they may assume, rather than prove, that market prices are both informationally and fundamentally efficient with respect to all available information.[207] In addition, Easterbrook and Fischel rely on data concerning the *average* price effects of successful and failed tender offers, but averages conceal the strong possibility that in *some* cases target shareholders did benefit, or might have benefited, from resistance.[208] Such a focus on averages would be proper only if there is no form of transfer-entitlement protection that would both allow loyal resistance and prohibit disloyal resistance. In short, the evidence upon which Easterbrook and Fischel rely is not dispositive, and may still leave logical room for the empirical intuitions of judges and academics. The ECMH has not answered all the questions and legal economists today confront the same dilemma they faced in 1982: available legal rules may be efficient or inefficient, depending on unanswered empirical questions.

TABLE 2: *Protecting the Transfer Entitlement*

		Policy Implication		
		Property-Rule Protection	Liability-Rule Protection	No Protection
Empirical Issue	Least-Cost Searcher	Bidder	Either/Or	Target
	Private Information	Fully Revealable	Either/Or	Imperfectly Revealable
	Public Information	Fully Reflected	Either/Or	Imperfectly Reflected

We have suggested above, however, that the putative dilemma may be an illusion. As summarized in Table 2, several of the subdebates on which the

206. Scherer, *supra* note 194, at 71.

207. *See, e.g.*, Bebchuk, *Tender Offers*, *supra* note 116, at 33-34 (noting that if the market sometimes inefficiently underprices some firms, it is unsurprising that there are gains to trade from takeovers); Kraakman, *supra* note 186, at 893-920 (reviewing the evidence and explaining how market underpricing may account for takeovers); Scherer, *supra* note 194, at 69 (reviewing event studies as well as accounting evidence and concluding that the totality of the data suggests that "[s]ome takeovers enhance efficiency, some degrade it, and the balance of effects, though not fully known, is most likely a close one"); *id.* at 72 (explaining how the event study results can be explained as the consequence of market error).

208. Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931 n.63 (1991) ("To say that 'on average' shareholders are made worse off by successful defense of course obscures the fact that in some instances shareholders might do better.").

entitlement debate hinges may be relevant when choosing between property rule protection and no protection. However, a liability rule, unlike its alternatives, does not force policymakers to take a position on these unanswered empirical and theoretical questions. Regardless of whether the bidder or the target is the least-cost searcher, whether private information is fully or only imperfectly revealable to shareholders, and whether public information is fully or only imperfectly reflected in stock prices, liability rule protection will, under our assumptions, yield the same efficient results. Put differently, whatever the circumstances, liability rule protection will be at least as efficient as its alternatives. For this reason alone, the case for liability rule protection is strong. Furthermore, as we discuss below,[209] the liability rule has the added advantage that it may help resolve the various unanswered empirical debates. Thus, our rule is Pareto superior to either of the present alternative legal rules for governing the behavior of target boards.[210]

6. *The Emergence of a Market in Resistance Bonding*

Our arguments in favor of a liability rule approach depend on our assumption that a robust market in resistance bonding would emerge were such a rule adopted and were resistance sometimes efficient. In this Section, we offer a defense of that assumption. First, we sketch how resistance bonding might work. We then describe why we believe the market would emerge notwithstanding possible impediments to contract. Finally, we argue that even given some uncertainty regarding a market in resistance bonding, the case for a liability rule remains strong.

---

209. *See infra*, Part II(C)(7).

210. We assume throughout this Essay that the goal of corporate law is to maximize shareholder wealth. Some scholars have argued, however, that corporate law should, in addition, serve the interests of stakeholders, such as managers and employees, who may be unable to protect their own interests through explicit private contracting. *See, e.g.*, John C. Coffee, *Shareholders versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986). Because of the potential threat that takeovers may pose to stakeholder interests, it might be argued that a rule allowing target managers to "just say no" is superior to a liability rule, which would enable them to reject only those bids that are not shareholder-wealth maximizing.

But the argument that stakeholders may sometimes be adversely affected by a takeover that maximizes shareholder wealth does not necessarily lead to such a conclusion. The possibility of legitimate stakeholder interests does not negate the possibility that managers may, to keep their jobs, resist shareholder-wealth maximizing bids even when the takeover would not threaten stakeholder interests. Moreover, even when a takeover would be deleterious to stakeholder interests, the takeover may create more than offsetting benefits to shareholders. Accordingly, target managements should not be afforded complete discretion to resist—especially where the takeover would, other things equal, substantially increase shareholder wealth. Thus, even stakeholder advocates may prefer a liability rule regime to a no-protection regime.

Finally, no matter how important the interests of stakeholders, it is not clear that takeover regulation is the place to protect those interests. One alternative means of protecting stakeholder entitlements (entitlements which, again, are thought to be too costly to protect through explicit ex ante contracting) is through some form of liability rule mechanism, such as tort law, in which the implicit entitlements are identified and vindicated ex post. *Cf.* CORPORATE LAW, *supra* note 2, at 90-93 (explaining that the fiduciary principle serves an analogous function between shareholders and managers where ex ante contracting costs are prohibitive).

a. *The Passivity Pill: Taking Rights Seriously*

To explain how a liability rule might work, we initially make several simplifying assumptions which we relax below. We assume first that there are only two states of the world: In State One, $P_t > P_b$; and in State Two, $P_t < P_b$. We assume further that resistance bonders have perfect information (i.e., they know P_t and P_b) and that there are no impediments to contracting. Finally, we assume that resistance bonders are willing to bond resistance for no profit—that is, they will put up the money at T_1 if they know it will be returned at T_2.[211]

Under our liability rule, recall, Target's management can prevent a takeover so long as it guarantees that target shareholders will be as well off at T_2 as they would have been had they been permitted to tender at T_1. Given our strong assumptions, a resistance bonder would bond a management in State One because, by assumption, P_m at T_2 would equal P_t ($> P_b$) so that the bonder would get back its bond (an amount equal to R). In State Two, the resistance bonder would not agree to bond management's resistance, because if it did, it would forfeit R at T_2. Thus, bonding would occur where it was shareholder-wealth-maximizing, but not otherwise.

When we relax the assumptions that there are only two states of the world and that bonders are perfectly informed, the picture becomes more complicated. Even if, at T_1, $P_t > P_b$, this may not be so at T_2. Therefore, suppose that Target and the bonder agree to the following arrangement. The bonder agrees to pay Target shareholders up to R to ensure that, at T_2, $P_m > P_b$. Using market price as a benchmark is ideal from shareholders' perspective, because it gives the bonder the correct incentives to look after shareholders' interest and the obligation to pay the bond is tied to objective market signals. To put the point another way, for a liability rule to work, a bonder's obligation to pay the bond must be keyed to P_m (which, by T_2, should equal P_t).

However, the problem with tying the bonder's obligation to market price is that stock market prices will, once there has been resistance bonding, reflect more than just shareholders' estimates of the firm's value: P_m will also reflect the value of the bonder's promise to ensure that $P_m = P_b$. This point can be expressed in the following way: let $P_{ab} + EB = P_m$, where P_{ab} is the market value of the company *absent the bond*, and EB is the expected payment of the bond. EB will fluctuate to keep P_m constant within a certain range.[212] In other words, as P_{ab} decreases, EB increases by the same amount so that P_m remains constant. Consequently, whenever $P_t < P_b$, P_m will nevertheless approach P_b because of the expected payment of the bond.[213] Therefore, it is not obvious how market

211. *See supra* Parts II(C)(2) and II(C)(3).

212. At T_2, where $P_{ab} + R > P_b$, $P_m = P_b$.

213. It will not equal P_b, because by paying P_b, a shareholder would dissolve the bonder's obligation to pay the bond. Thus, the stock will trade at P_b, less a penny. We assume that stock price manipulation is either impossible or preventable.

price might be employed as a measure of the value of Target's new projects (V)—and thus, of the bonder's obligation to pay shareholders the promised amount. The puzzle is how to objectively determine P_t at T_2—that is, how to disaggregate the effect of the bond (EB) from P_m.[214]

Although the value of P_{ab} at T_2 might be settled by resort to appraisers, this is unlikely. Appraisal is, at best, an inexact practice and appraisers in this situation have imperfect incentives. Target's management and the resistance bonder both share the incentive to find an appraiser who will vindicate resistance, regardless of its loyalty.[215]

In sum, without a market measure of P_{ab}, liability rule protection seems unworkable because there is no way to objectively determine bonders' obligation to shareholders. This puzzle may explain why scholars and courts have previously overlooked the liability rule alternative. To make a case for a liability rule approach, it is necessary to suggest a way in which the value of Target's stock *absent the bond* (P_{ab}) can be teased out of P_m.

To isolate P_{ab}, our proposed liability rule would, in effect, add a "rights plan" to all firms' articles of incorporation.[216] For convenience, we call this rights plan a "passivity pill" because, absent compliance with such a plan, target management must respond passively to tender offers.[217] These passivity pills would provide all shareholders with roughly the following:

214. *Cf.* CORPORATE LAW, *supra* note 2, at 154 ("The principal difficulty with relying on market price . . . [is that] the price may have been influenced by the transaction [at issue] . . . ."). Indeed, a related problem undermines one company's attempt to devise liability rule protection for its shareholders. In 1986, Laidlaw Transportation initiated a tender offer for the Mayflower Group. Because any defensive measure was likely to be reviewed by the Seventh Circuit, which had recently announced that defensive measures should be "plausibly related to the goal of stockholder wealth maximization," Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986), *rev'd*, 481 U.S. 69 (1987), Mayflower management attempted both to resist and to guarantee shareholders the benefit of the premium. *See* Fraidin & Golden, *supra* note 137, at 38-39. Mayflower's "Value Assurance Plan" contemplated that "if the value of [target] shares does not equal a . . . price equal to $.75 more than the Laidlaw offer price (as increased by interest to compensate for the passage of time) during the two-year life of the plan, Mayflower [would] be required to pay the difference between the target price and the value of the stock." *Id.* To accomplish this goal, Mayflower issued "contingent unsecured notes" to shareholders that traded separately from the stock and promised to pay the holder the difference between the foregone premium and the actual stock price.

While a laudable attempt to solve the problem of disloyal resistance, the "Value Assurance Plan" is not a completely satisfactory solution. The problem with the plan is that the notes are obligations of the corporation to be paid for with corporate assets. It therefore does not avoid the problem of management self-dealing. The issuance of the plan does not create corporate value, but simply allocates the value between the notes and the shares. Any positive value of the notes represents a corresponding decrease in the value of the stock. Thus, the notes' maximum value is equal to the pre-bid price of the shares (at which time the shares are worthless—as all of the corporations assets must be liquidated to pay off the notes.) In short, if the market has already evaluated a company to be worth $100, management's unbonded promise to pay more than $100 will not be credible. Of course, if such a plan would create corporate value, managers could and should issue such a plan at any time, regardless of whether they faced a hostile bid.

215. *Cf. infra* text accompanying note 224 (discussing the problems with fairness opinions).

216. This may, at least in the short run, need to be a mandatory term. *See infra* note 242.

217. As we explain below, the name should signal the fact that our plan would have the opposite effect of the conventional poison pill. *See infra* text accompanying notes 220-21.

> In the event of a tender offer, the management may not resist a takeover bid absent third party bonding pursuant to the "rights." The rights entitle holders to the pro rata portion of the total amount that must be paid to the firm by the third party bonder at T_2 to increase P_m to some amount greater than P_b.

To see how such a rights plan allows for a market valuation of the firm, imagine that at T_2, P_m is \$99.99 where the bonder is obligated to pay up to \$25 if P_{ab} at T_2 is less than \$100. Imagine further that P_{ab} is \$90. The bonder is clearly obligated to pay something to shareholders (*EB*), but how much? *EB*, \$10, is not observable; only P_m is observable. Our solution, the passivity pill, would rely on the market to determine *EB* and P_{ab}. This may be done by establishing an escrow account to which rights holders have pro rata claim. The bonder must gradually pay into the account until $P_m > 100$, at which point *EB* would equal the amount of money in the account.[218]

Notice that shareholders would, under such a plan, receive at least P_b and up to P_t. This assures that shareholders at T_2 are as well off as if they had been given the chance to tender at T_1. Shareholders are better off ex ante than they would have been had resistance been impossible.[219]

We have sketched one of several possible methods by which shareholders could be guaranteed the value of a takeover premium (their transfer entitlement) while management is simultaneously given the chance to mount any defense that is loyal. The key element of this rights plan is that it protects shareholders' transfer entitlement by providing for a market test for management loyalty. This plan is in stark contrast to conventional "rights plans" or poison pills.[220] Conventional plans, ironically named "rights plans," actually *take away* shareholders' transfer entitlement. A passivity pill, in contrast, truly protects shareholders' rights by providing liability rule protection for their transfer entitlement.[221]

---

218. P_m might be distorted if shareholders strategically refused to sell stock for more than \$100 in order to avoid extinguishing the Bonder's obligation to continue making payments into the account until the bonder pays the whole amount *R* into the account. This problem is avoidable by periodic auctions or planned sales of a small number of treasury shares in order to get a market test of the firm's value. Additionally, it may be that public shares will be sold due to shareholders' liquidity constraints and, once up for sale, the bid prices would accurately reflect the value of the firm.

219. We ignore the possibility that $P_{ab} < P_m$ at T_1, in which case shareholders would still receive $P_{ab} + R$, but less than P_b. In such a case, therefore, shareholders would wind up worse off but that is true for either or both of two reasons, neither of which provide grounds for intervention. It may be true, first, because at T_2, $V < 0$, notwithstanding the fact that, at T_1, $V > R$. Thus, from an ex ante perspective, shareholders were better off—i.e., management's decision was loyal. Alternatively, P_{ab} may be less than P_m at T_1 owing to variables that are not firm-specific. That possibility is one that can, to some degree, be contracted around with the aid of event studies which can control for non-firm-specific changes in market price. *See generally* CORPORATE LAW, *supra* note 2, at 192-94 (describing the usefulness of event studies); Macey et al., *supra* note 183, at 1028-42 (describing event study methodology).

220. For a description of conventional poison pills, *see* CORPORATE LAW, *supra* note 2, at 164.

221. Although we have considered just one, liability rule protection may be provided in a variety of ways. For instance, target managements might be permitted to purchase a "passivity put," which would entitle shareholders to sell their shares at T_2 at an exercise price of P_b to the resistance bonder. A passivity pill

b. *Why It Would Work*

Some readers may find the assumptions underlying our liability rule proposal to be unrealistic. In this Subsection we suggest that the assumptions underlying our proposal are actually more realistic than those underlying justifications of the current regime.

---

may be preferable to a passivity put inasmuch as the former would require the resistance bonder to place less capital at risk. That is, a resistance bonder would put only R at risk under a passivity pill, but would put P_b (= $P_m + R$) at risk under a passivity put. Note, however, the additional money that a resistance bonder would need to raise under a passivity put, P_m, may be relatively easy to come by, given that the stock market already values the target at P_m.

In any case, if the benefits of liability rule protection might be obtained by buying the right to sell the target at T_2, then why is it not possible to obtain the same benefits by selling the target at T_1? The answer has to do with the nature of the potential conflicts of interest that threaten the loyalty of target managements.

Broadly speaking, courts and commentators agree that there are two potential conflicts of interest that justify heightened judicial scrutiny of target managements' decisions. First, a target management may be motivated by a concern for job security to resist a shareholder-wealth maximizing bid or to not reveal nonpublic information to a particular bidder. Second, the target management may attempt to appropriate the value of the information for itself. These problems would be overcome under our proposed liability rule approach. To be sure, where the management does resist under a liability rule regime, the management may be motivated in part by its own interest in job preservation. However, the management will be able to resist successfully only where resistance is loyal. Furthermore, under resistance bonding, shareholders remain the residual claimants and thus retain their claim to the firm's true value.

At first blush, it would seem that these conflicts of interest would also be overcome if shareholders' transfer entitlement were protected by an "auction rule." *See generally* Bebchuk, *Facilitating Competing Tender Offers*, *supra* note 109; Bebchuk, *Reply*, *supra* note 116; Gilson, *Structural Approach*, *supra* note 116; Gilson, *Tender Offer Defense*, *supra* note 118. An auction rule would require managers (i) to seek competing bidders, (ii) to disclose to all competing bidders nonpublic information regarding the target's true value, and (iii) to sell to the highest bidder. Under such a rule, just as under a liability rule, shareholders would receive at least P_b and up to P_t. There are several problems with an auction rule, however. For instance, the requirement, that all nonpublic information be disclosed to potential bidders, may sometimes have the effect of lowering the target's true value. That is, where the nonpublic information can be appropriated by others, disclosing it to potential bidders would likely eliminate its value to the target and thus hurt target shareholders. *See supra* note 167 and accompanying text.

Moreover, even if the value of the nonpublic information is useful only to the target, the disclosure requirement would be very difficult to enforce, particularly where the nonpublic information at issue is "soft." *See supra* notes 170-173 and accompanying text. Consequently, target managements would be able to use their information disloyally in pursuit of job entrenchment. For instance, they could provide the information only to a favored third party bidder, or they could appropriate the value of the information themselves by becoming a bidder through a management buyout. In either case, an auction rule will not provide shareholders the full value of the nonpublic information, because only the informed bidder will know the target's true value. The informed bidder will bid just over the bid of the highest, uninformed bidder. Put differently, under an auction rule target shareholders would receive just over P_b, not P_t. *See* Victor Brudney & Marvin Chirelstein, *A Restatement of Corporate Freeze-Outs*, 87 YALE L.J. 1354, 1367 (1978) (arguing on this basis that management buyouts should be prohibited); James R. Repetti, *Management Buyouts, Efficient Markets, Fair Value, and Soft Information*, 67 N.C. L. REV. 121 (1988) (arguing on this basis that disclosure requirements should be enhanced in management buyouts).

In contrast, under a liability rule regime, target managements are not motivated by job security concerns when choosing among resistance bonders, because their jobs will not be at stake if resistance bonding is obtained. Target managers can thus be trusted to choose a bonder loyally, just as managers are trusted to make business decisions loyally. It might be argued that an auction rule would yield the same result if successful bidders were prohibited from ousting incumbent managements. But that is no solution, for in some cases ousting incumbent managements is shareholder-wealth maximizing. The goal of liability rule protection is not to protect the jobs of all target managements, but to protect only those target managements whose value to the target meets or exceeds that of the bidder ($P_t > P_b$). An additional relative disadvantage of the auction rule is that it may facilitate disloyal resistance. *See supra* text accompanying note 80.

We characterized the current regime as a "just say no" regime.[222] At a different level of abstraction, however, the current regime is strikingly similar to the one we propose: both require a form of third party resistance bonding. Under the current regime, target managements are virtually required to obtain a "fairness opinion"—in which an investment bank offers its view as to the "adequacy" or "fairness" of the bid—before resistance is allowed.[223] Thus, it is not enough to "just say no." Successful resistance depends also on a fairness opinion that finds, in effect, that $P_t > P_b$. Insofar as an inaccurate fairness opinion has adverse reputational consequences for its author, fairness opinions constitute a type of third party bonding. As has been well covered elsewhere, however, those reputational consequences are overwhelmed by investment bankers' conflicting interest in pleasing their clients—the target managements. As Lucian Bebchuk and Marcel Kahan have summarized: "These conflicts encourage investment banks to render the opinions most conducive to the interests of the managers that hired them, and not those that best reflect the bankers' genuine beliefs.... [N]either reputational concerns nor internal procedures and guidelines will significantly diminish this problem."[224] In sum, the difference between the current regime and our proposed regime is not that only ours requires that managements obtain resistance bonding. The difference is that only ours requires bonding that is effective: only bonders willing to put their money where their mouths are will be allowed to affect shareholder wealth.

Our proposal is also similar to one made by Ronald Gilson and Reinier Kraakman, and briefly adopted by Delaware courts.[225] Gilson and Kraakman argued that Delaware's "proportionality test"[226] could and should be used as an "intermediate standard" for reviewing defensive tactics so as to resolve the judicial dilemma between, on one hand, mitigating target managements' conflict of interest in the takeover context and, hence, applying the "intrinsic fairness test" and, on the other hand, freeing target managers to focus on the complex business decisions that need to be made in this context and, hence, applying the business judgment rule.[227] According to Gilson and Kraakman, "substantive coercion"—that is, "the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic

---

222. *See supra* Part II(B).

223. *See* Lucian A. Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27, 27-28.

224. *Id.* at 29; *see also* CORPORATE LAW, *supra* note 2, at 155 ("The collective judgment of thousands of self-interested investors, voting their wallets, is more likely to be accurate than a guess by a single appraiser hired to serve a party's cause."); Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW 1437, 1453 (1985); Robert J. Guiffra, Jr., Note, *Investment Banker's Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119, 127-28 (1986).

225. *See generally* City Capital Assocs. v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988) (adopting a proportionality test analogous to Gilson and Kraakman's proposal); Paramount Communications v. Time, 571 A.2d 1140, 1153 (Del. 1989) (rejecting a proportionality test); Gilson & Kraakman, *supra* note 136.

226. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (defensive tactics must be reasonable in relation to the threat posed).

227. Gilson & Kraakman, *supra* note 136, at 274.

value"[228]—may occur if, by managing the company better than the market expects, management can better the terms of the hostile offer.[229]

Under both our proposed liability rule and Gilson and Kraakman's proposed standard, an allegation of substantive coercion would require "a showing of how—and when—management expects a target's shareholders to do better."[230] However, under the Gilson-Kraakman standard, target managements would make such a showing to a judge, a *public* third party resistance bonder not subject to the discipline of the market. Courts would, under that standard, weigh "whether management's plans present a plausible story: a goal that improves on the value of the hostile offer and a means that is reasonably likely to achieve the goal."[231] The Delaware Supreme Court abandoned the proposal on the grounds that it "involve[s] the court in substituting its judgment as to what is a 'better' deal for that of a corporation's board of directors," and thus recreates the very dilemma that gave rise to it.[232] Note, however, that the court objected not to the idea of resistance bonding, but to the implicit assumption that a court can be an effective resistance bonder.[233]

---

228. *Id.* at 267.

229. *Id.* at 268.

230. *Id.*

231. *Id.* at 270-271.

232. Paramount Communications v. Time, 571 A.2d 1140, 1153 (Del. 1989).

233. The court's criticism reflects an oversimplified understanding of how an intermediate standard would work. According to Gilson and Kraakman, few, if any, difficult substantive judgments would need to be made by courts under a proportionality test because of "the systemic institutional effects of searching judicial review." Gilson & Kraakman, *supra* note 136, at 271. "Although courts are not better equipped to evaluate management's representations about future value than the market, the important point is that courts do not need to be more expert than the market to play a screening role." *Id.* at 273.

Gilson and Kraakman's defense is not altogether persuasive, however. They argue, for instance, that the process of making a case for resistance would force target managements to obtain appraisals by investment bankers of the management's specific plans:

> For an investment banker, passing on the credibility of a specific management plan would differ from merely opining on the fairness of an offer price because it would involve both greater specificity and an accountability check. Management's plan will eventually either succeed or fail for reasons likely to be discernible at the time the opinion was rendered; subsequent events will measure the quality of the investment banker's earlier opinion. Thus, the reputational consequences of supporting ill-conceived plans would encourage a considerable measure of private enforcement by investment bankers.

Id. at 272. But under the current regime, a fairness opinion claiming that a specific bid is inadequate because of some unspecified plan is no more difficult to verify than the more "specific" opinion contemplated by Gilson and Kraakman. The target's stock price will either increase to some amount greater than the failed bid or it will not. Accordingly, there appears to be as much potential for "accountability" under the current regime as there would be under the proportionality standard. The problem is not whether it is possible to measure the accuracy of investment bankers' valuations, but rather whether anyone has the incentive and the ability to hold investment bankers accountable. Under the current rule as well as under a proportionality standard, target shareholders are the ones injured by inaccurate appraisals, but the opinions (good or bad) of shareholders have little or no consequence among investment bankers.

Gilson and Kraakman also argue that successful resistance on the part of a target management would, if the specified plan justifying the resistance failed, "undermine its credibility and open the target to the [takeover] market. . . . At most, misrepresentation at the time of the initial offer would only buy target management temporary relief from the acquisitions market." *Id.* at 273. However, this argument seems to overlook the fact that a venture undertaken by loyal management can also fail. Indeed, it is commonly assumed that shareholders are interested in the *expected value* of a project, not the probability of a project's success or failure. Thus, it is not clear that failure would undermine credibility with courts or, if it did, that it should.

In sum, the notion of employing third party resistance bonders to help protect shareholders' interests is far from novel. What is new, however, are the two aspects of liability rule protection that we believe would make it superior to its alternatives. First, it relies on market institutions rather than regulatory institutions to do the appraising and bonding. Second, liability rule protection insures that the bonder's decision is in sync with shareholders' interest by tying the bond to the share price and by requiring that the bond be as substantial as shareholders' potential loss from unbonded resistance.[234]

One need look no further than Easterbrook and Fischel's new book to find support for both of these new aspects of liability rule resistance bonding. Easterbrook and Fischel encapsulate both aspects with the following admonition: "Talk is cheap; anyone can project intrinsic value; when projections are backed by money the most accurate prevail."[235] Bringing us full circle, this "money talks" proposition is a central tenet both of the efficiency thesis and of our own liability rule. Indeed, at one point Easterbrook and Fischel write: "'Put your money where your mouth is' should be the key adage of corporate control transactions, as of commerce in general."[236] From this tenet flow two of the assumptions underlying our case for liability rule resistance bonding: (1) money talks; and (2) lots of money talks a lot.

The first assumption runs parallel to Easterbrook and Fischel's conclusion that judges and academics cannot be trusted to know what is best for shareholders. As they put it:

> [T]he people who are backing their beliefs with cash are correct; they have every reason to avoid mistakes, while critics (be they academics or regulators) are rewarded for novel rather than accurate beliefs. Market professionals who estimate these things wrongly suffer directly; academics and regulators who estimate wrongly do not pay a similar penalty. Persons who wager with their own money *may* be wrong, but they are less likely to be wrong than are academics and regulators, who are wagering with other peoples' money.[237]

CORPORATE LAW, *supra* note 2, at 98 ("Only after learning all of the possible outcomes, and the probability attached to each, could the court determine the wisdom of the decision at the time it was made."). While we are persuaded that Gilson and Kraakman's proposed intermediate standard may well represent an improvement over the current approach, we are less sanguine than they that such a standard would rarely require courts to make substantive (that is, business) judgments. The market incentives behind reputational consequences are not as strong as they would be under our proposed rule.

234. *See infra* note 241.

235. CORPORATE LAW, *supra* note 2, at 207.

236. *Id.* at 208.

237. *Id.* at 31; *see also id.* at 100 ("However much judges want to decide cases 'correctly,' they do not receive extra pay for extra work or more astute estimates of market conditions. Inferior managers eventually are 'selected out' by competitive process. Investors likewise are selected out, and markets therefore tend to value decisions accurately. Judges are neither chosen for business acumen nor fired or subject to reductions in salary if they err in assessing business situations.... It is better to insulate all honest decisions from review than to expose managers and directors to review by judges and juries who do not face market pressures."); *id.* at 98 (arguing that courts are not very good at "detecting and rectifying shortcomings in the boardroom").

We believe that our second assumption also underlies Easterbrook and Fischel's argument that creditors are more reliable appraisers and monitors than shareholders are, because creditors often have larger, more concentrated capital investments at stake. Put differently, those with the highest ratio of money to talk deserve the greatest deference:

> Banks and other institutional investors tend to have specialized knowledge about particular industries and may be good monitors of major decisions such as whether to build new plants. The lender may provide financing to several firms in an industry and thus augment this knowledge. These debt investors commonly negotiate detailed contracts giving them the right to disapprove managers' decisions that are important enough to create significant new risk for the firm, though perhaps not important enough to spark a contest for control.
>
> . . . .
>
> . . . Compare the situation of a sophisticated shareholder with that of a sophisticated creditor . . . . Even if the sophisticated shareholder has the ability to monitor, he has little incentive to do so. He bears all the costs, but the benefits accrue to all other shareholders according to the size of their holdings. The creditor, by contrast, captures more of the benefits of his monitoring activity, because there are fewer other members of the same class of investor.[238]

So, Easterbrook and Fischel conclude: "Concentrating the entire marginal gain and loss on one group of investors induces them to make the appropriate expenditures on monitoring . . . ."[239]

Easterbrook and Fischel's description of creditors would apply equally to resistance bonders under a liability rule approach, for resistance bonders are, in all ways pertinent, equivalent to creditors. Indeed, Easterbrook and Fischel argue that, under the current regime, creditors are performing a function quite similar to the one that resistance bonders would perform under a liability rule regime. That is, creditors currently bond managements (for the benefit of shareholders) by providing, in effect, a type of "failure insurance":

> Creditors might have a comparative advantage in assessing the riskiness of a transaction initially and superior ability to monitor the conduct of the firm for the duration of the agreement—particularly to prevent the increased risk taking that is an effect of all insurance. In other words, the firm would buy its insurance from the creditors. This is essentially what we observe. The creditors assume some risks of business failure, just as they would if they were 'insurers' as well as creditors.[240]

---

238. *Id.* at 46-47.
239. *Id.* at 45; *see also id.* at 51-52, 114 (describing further the comparative advantage of creditors).
240. *Id.* at 48.

If failure insurance is *already* a common part of creditor-debtor contracting,[241] it seems only a small stretch to believe that failure insurance, in the form of resistance bonding, might also emerge were there sufficient demand for it.[242]

---

241. Elsewhere within the corporate law context, forms of third party bonding are common. *See* Gilson & Kraakman, *supra* note 160, at 619-21. (discussing the benefits of investment banker bonding as a source of information); Haddock et al., *supra* note 27, at 730-33 (explaining how firms could bond to passivity: "When doubts exist about contractual reliability outside the corporate control market, third party bonding to assure performance often resolves them."). Moreover, outside of corporate law, such examples abound. For instance, "completion," "contract," or "performance" bonds are often employed in construction contracts. Such guaranty agreements contain a third party's promise to complete or pay for the cost of completing a construction contract if the construction contractor defaults. Likewise, in liability insurance arrangements, the insurer agrees to compensate persons to whom the insured becomes liable. *See generally* Gary T. Schwartz, *The Ethics and Economics of Tort Liability Insurance*, 75 CORNELL L. REV. 313 (1990). Bonding arrangements are also common in agricultural and real estate markets. *See* Charles R. Knoeber, *An Alternative Mechanism To Assure Contractual Reliability*, 12 J. LEGAL STUD. 333, 334-43 (1983); *see also* Macey et. al., *supra* note 183, at 730-33 (describing how third party bonding could be used to insure passivity). *See generally* Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 635-37 (1981) (suggesting that third party enforcement is often the cheapest method of assuring performance).

242. As with any type of insurance, a market for resistance bonding would have to overcome the problem of "moral hazard"—that is, the tendency of insureds to engage in more loss-producing behavior because they are insured. But just as creditors and insurers can control for moral hazard, so may resistance bonders. *See infra* note 254 and accompanying text. *See generally* Mark Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991); Steven P. Croley & Jon D. Hanson, *What Liability Crisis? An Alternative Explanation for Recent Events in Products Liability*, 8 YALE J. ON REG. 1 90-110 (1991) (describing various mechanisms available to liability insurers for mitigating moral hazard problems). Moreover, managers would have better incentives under liability rule resistance bonding than they do under its alternatives. Managers who do not hold up their end of the deal will be less likely to obtain resistance bonding in the future and, hence, will take their job security into account even once a resistance bond is in place. In sum, the agency costs that shareholders must pay may well be reduced under a liability rule approach inasmuch as such an approach shifts the monitoring function to resistance bonders. Thus, shareholders should prefer liability rule protection to the current regime.

By arguing that liability rule protection may be the form of protection that shareholders would most prefer, we raise the question why such a rule has not already arisen by contract. Of course, it is possible that the rule has not emerged simply because it has not occurred to anyone. It is possible, in other words, that what appears to be a twenty dollar bill on the sidewalk is just that. That possibility seems remote, however, given that we are walking a well used sidewalk. We do not predict, therefore, that upon publication of this essay firms will begin contracting to the liability rule approach.

A second possibility is that corporate charters, though generally efficient, may generally contain inefficient terms regarding management's duties during a takeover. *See supra* note 112. If so, then the rule has not emerged because courts and contracts have not required management to compensate shareholders for disloyal resistance. There is evidence to confirm this possibility. When target firms expected their defensive measures to be reviewed by judges suspicious of disloyal resistance, targets actually began to develop forms of liability rule protection. *See* Fraidin & Golden, *supra* note 137.

Finally, liability rule protection has not emerged by contract because a necessary condition for its emergence—that is, a market in resistance bonding—does not exist. Where there is no active market in resistance bonding, a contractual term between shareholders and management of a given firm will probably be insufficient to give rise to a reasonably competitive market in resistance bonding. Where such a market does not emerge, shareholders would likely be made worse off by contracting to a liability rule that would be a de facto property rule contract. But there is good reason to believe that property rule protection is inferior to the current no-protection regime. Evidence for that is strong: No firms contract out of the no-protection rule to property rule protection. Doing so would eliminate any flexibility on the part of target managements. They would be unable to resist no matter the terms of the bid. As we explain above, however, flexibility may be desirable, because of the possibility that tender offers will be made in which $P_b < P_r$. In sum, the absence of a market for resistance bonding means that contracting to a liability rule approach would be contracting to a property rule approach, which shareholders have demonstrated an unwillingness to do. Thus, firms face a kind of prisoner's dilemma. If they all (or many) contracted to liability rule protection, a market in resistance bonding might well emerge and the firms would all be better off. But if any one firm contracts to liability rule protection, that firm takes the significant risk that a reasonably competitive market in resistance

Thus, our assumption that a market for resistance bonding would emerge should be plausible, at least to Easterbrook and Fischel.

In previous Sections, we explained the benefits of a liability rule protection of shareholders' transfer entitlement. In this Subsection, we explained how and why a liability rule might work. Before concluding, we think it important to emphasize that our brief arguments support only very tentative conclusions. The questions we broach here are complicated, the stuff of future research.[243] But that does not mean that we are not genuinely calling for the adoption of a liability rule approach. After all, even if the market does not emerge, this fact is itself highly informative and pertinent to the selection of appropriate legal standards.[244] The very worst our proposal can bring is a de facto property rule regime of the sort that scholars such as Easterbrook and Fischel have been advocating for a decade.

7. *The Law as a Laboratory*

Beginning with Christopher Columbus Langdell, there has been an urge among some legal scholars to characterize law as a science. Langdell wrote: "Law, considered as a science, consists of certain principles or doctrines. To have such a mastery of these as to be able to apply them with constant facility and certainty to the ever-tangled skein of human affairs, is what constitutes a true lawyer."[245] Although Langdell's notion of the law as a natural science—equivalent to chemistry or biology—gave way to other trends in legal scholarship, the aspirations to science persist. In the 1970's, legal scholars in the law-and-economics movement began anew the positivist project of "link[ing] the rules of . . . law to fundamental principles."[246] Picking up where Langdell's efforts failed, their goal was "to construct an alternative approach which [would] permit lawyers to analyze legal problems in a disciplined way."[247]

---

bonding will not emerge. Because firms cannot make this move collectively, there will be no contracting to liability rule protection. This explanation provides a possible justification for making liability rule protection a mandatory rule for at least long enough for a market in resistance bonding to emerge, if one is ever going to emerge.

There is a final way of resolving the puzzle between what we claim is efficient and what we observe in the real world. The puzzle assumes the efficiency of corporate law. Some reject that assumption and thus find no puzzle at all.

243. We have ignored, for example, the fact that the market for resistance bonding would likely need to be regulated, as are all capital and insurance markets. The costs of such regulation can be substantial, even prohibitive. *See generally* Howell E. Jackson, The Expanding Obligations of Financial Holding Companies (July 30, 1992) (unpublished manuscript, on file with authors).

244. *See infra* Part II(C)(7).

245. ARTHUR E. SUTHERLAND, THE LAW AT HARVARD: A HISTORY OF IDEAS AND MEN 1817-1967 174 (1967).

246. BRUCE ACKERMAN, ECONOMIC FOUNDATIONS OF PROPERTY LAW viii (1975).

247. *Id.* at ix. This view of law and economics as the heir to the Langdellian tradition is not always explicitly recognized, but often pervades such scholars' self-characterization. For instance, in the introduction, Bruce Ackerman all but states that law and economics promises to expose the "fundamental legal order" that eluded Christopher Columbus Langdell. *Id.* at vii-xvi.

Initially, the law and economics scholars embraced two goals. The positive goal was to show that laws are, on the whole, efficient (or wealth maximizing).[248] Put differently, the goal was to show that law truly is a science, and is thus explainable by reference to a single governing principle—efficiency. But the positive project of law and economics has been all but abandoned in the last decade.[249] Legal economists have turned instead to the normative project of identifying and proposing efficient (wealth maximizing) laws. Thus, Easterbrook and Fischel's book—arguing that corporate law *is* efficient—constitutes the latest attempt to revive the view that law is a science. In Part I, however, we argued that Easterbrook and Fischel's science is threatened by at least one fundamental anomaly—the corporate law paradox.

But even Easterbrook and Fischel's normative project is subject to the criticism that their proposals, like those of many instrumentalists, are based on unproven empirical assumptions. As we argued above, the debate over how a target management should respond to hostile takeover attempts, for instance, culminated in a set of policy proposals each of which was based on debatable empirical assumptions. And the empirical questions remain unanswered. We are therefore sympathetic to critiques of proposals of legal economists on the grounds that their conclusions "are invariably grounded in unwarranted a priori theorizing, and that proving them valid in particular cases would require empirical evidence that is either utterly unavailable or far less convincing than the [legal economists] would wish."[250] We are not persuaded, however, that the pursuit of efficiency through the law—particularly corporate law—is *invariably* based on utterly unavailable empirical support. Indeed, such an empirical claim that empirical claims are always suspect is—and must be—suspect.[251] More important, if it is true that normative proposals are often based on insubstantial empirical support, this may suggest an enhanced, not reduced, role for instrumentalism. In addition to promoting efficient behavior and outcomes, the law might be used to obtain some of the empirical evidence that is otherwise unobtainable. Put differently, instead of viewing law as a science, legal economists should consider law's potential as a "laboratory."

---

248. The most notable such effort is RICHARD POSNER, THE ECONOMIC ANALYSIS OF LAW (1986). *See id.* at 21 ("The theory is that the common law is best (not perfectly) explained as a system for maximizing the wealth of society.").

249. *See* George L. Priest, *Measuring Legal Change* 3 J. L. ECON. & ORGANIZATION 193, 193 (1987) ("The Langdellians may have believed that one could discover—like Newton—a small number of immutable principles that controlled the vast structure of law, but to maintain such a position today would be proof of dementia.").

250. MARK KELMAN, A GUIDE TO CRITICAL LEGAL STUDIES 152-53 (1987).

251. For examples of useful empirical work in this area, see, for example, Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L., ECON. & ORGANIZATION 89 (1991); Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987); Howell E. Jackson, Capital Maintenance Obligations and Their Effect on Savings and Loans Associations with Substantial Holding Companies (May 29, 1992) (unpublished manuscript, on file with authors).

As we suggested at the end of the previous section,[252] adopting a liability rule may shed valuable light upon unanswered empirical questions. Among other things, a liability rule might substantially resolve the corporate law paradox because it provides a market test of the competing hypotheses. For example, if, under a liability rule approach, a robust market in resistance bonding emerged and target managers resisted a significant portion of takeover attempts, this would suggest several things. First, it would suggest that a mandatory rule of pure passivity would not be efficient or, in other words, that the true value of the target sometimes exceeds the bid. Of course, if the true value exceeds the bid, then it must also exceed the firm's market price, which suggests that stock market prices do not fully reflect all information.[253] If, on the other hand, no significant market in resistance bonding emerges, this would suggest one or both of two possibilities. Either resistance is in fact inefficient ($P_b > P_t$) or the costs of contracting, C, are so high that bonding does not occur even when Target's true value exceeds the bid ($P_t > P_b$, but $C > G$).[254] The former result implies that stock prices reflect all information. No conclusion can be drawn about the efficiency of the stock market from the latter result.[255] In this way, a liability rule approach would not only yield efficiency over a greater range of empirical

252. *See supra* text accompanying note 244.

253. *See supra* Parts II(C)(3) and II(C)(4).

254. Readers may wrongly conclude that whenever the costs exceed the gains of contracting with a resistance bonder ($C > G$), the current "just say no" regime is superior to our proposed liability rule regime. Under the current regime, managements can obtain the gains of resistance, G, without incurring the costs of contracting with a resistance bonder, C. It is important to note, however, that shareholders under the current regime bear some of the same types of costs that, by hypothesis, prevent a market in resistance bonding from emerging. Resistance bonding insures shareholders against the cost of disloyal resistance. And, where managers cannot obtain insurance for shareholders, shareholders must self-insure. For instance, that moral hazard problems may render contracting between target managements and resistance bonders prohibitively costly does not imply that those costs will be saved in a no-protection regime. Instead, shareholders will bear these costs. Indeed, these costs may well be higher in a no-protection regime, because resistance bonders are likely to write more detailed contracts than shareholders, and to be better able to monitor managers. *See supra* notes 238-42 and accompanying text (describing the likely monitoring advantages of resistance bonders). *Cf.* Clifford W. Smith, Jr., & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979) (describing the detailed contracts with which creditors protect themselves). Under the current regime, therefore, there are "contracting costs," C^*, that shareholders must bear. To make a case for the current regime over a liability rule regime, it is not enough to argue that there are prohibitive contracting costs that would prevent a market in resistance bonding from emerging. It must also be shown that the costs borne by shareholders under the current no-protection regime are less than the gains from resistance ($C^* < G$).

255. Under *any* of the alternative scenarios, however, Easterbrook and Fischel's efficiency hypothesis suffers. First, if a market for resistance emerges, this suggests that the stock market is inefficient, so that one of the important mechanisms of managerial discipline and, hence, of efficient contracting is not as accurate as Easterbrook and Fischel would like. And the fact that liability rule protection has not emerged by contract should further weaken Easterbrook and Fischel's confidence in the strength of markets and contracts to reach efficiency. Second, if a market for resistance does not emerge such that liability rule protection is equivalent to property rule protection, then that would suggest that corporate law is inefficient for one of two reasons. If passivity is *efficient*, the fact that we have not seen it contracted to prior to the adoption of the liability rule approach implies that the corporate law is inefficient. In this case, passivity would have arisen only because it was, in effect, made mandatory. In that case, the passivity thesis has been vindicated at the expense of the efficiency thesis. On the other hand, if passivity is *inefficient*, as current contracts suggest, then it must be that contracting costs, C, prevent firms from contracting away from inefficient passivity. If contracting costs are this high, corporate charters are entitled to less of a presumption of efficiency.

circumstances than would alternative approaches, it might also contribute to our understanding of corporate law and capital markets.[256]

Broadly speaking, participants in the debate over the proper role of target management agree on three things. First, resistance is sometimes loyal and sometimes disloyal. Second, courts are generally incapable of distinguishing the former from the latter. Finally, although more empirical evidence would be useful, policymakers must base their policies on the scant empirical evidence that now exists. We share the first view, but consider the second inapposite and the third mistaken. Our proposal, unlike either of its alternatives, would separate loyal from disloyal resistance, encouraging the former and discouraging the latter. A liability rule approach would rely not on courts but on the market to make that distinction. And while we do agree that there is presently substantial empirical uncertainty, our policy proposal would render many of the empirical disputes moot. Courts and commentators have overlooked what may be a Pareto superior alternative: Liability rule protection not only satisfies the concerns of a wide range of commentators on a variety of subjects but also reveals important information useful in designing legal rules in other contexts.

CONCLUSION: TWO CHEERS FOR *CORPORATE LAW*

This Essay has examined two ways for scholars to function in the face of opposed ideas and unresolved paradox. First, scholars may, like Easterbrook and Fischel, turn their analytical skills to constructing theoretical accounts that are as persuasive and comprehensive as possible. *The Economic Structure of Corporate Law* is evidence that, if done with great skill, this approach can be a profitable one. The efficiency thesis explains much and is likely to be a dominant view for years to come.

Nevertheless, the thesis has important shortcomings and should be greeted with the tempered enthusiasm of only two cheers. The first shortcoming is a failure of explanation: the thesis contradicts Easterbrook and Fischel's own passivity thesis, and any attempt to explain away the conflict undermines one thesis or the other. There are only two ways to explain why passivity, if efficient, has not arisen by contract: either its costs are too high or its benefits too low. Neither is consistent with the efficiency thesis. If, as seems unlikely,[257] passivity contracts are prohibitively costly to write,[258] the efficiency thesis

256. There may be many areas in which restructuring corporate law would yield sizeable payoffs. For instance, an extremely important debate is currently being waged over whether and to what extent background rules should be mutable or mandatory. *See, e.g.*, CORPORATE LAW, *supra* note 2; Symposium, 89 COLUM. L. REV. 1395 (1989). The debate is quickly bogging down, however, in seemingly unanswerable empirical disputes over the likely effects of different default rules. This is an area in which some lab work might prove beneficial not only in reinvigorating stalled academic debates but also in locating efficient default rules. *Cf.* Ayres, *supra* note 41.

257. *See supra* note 41 and accompanying text.

258. Easterbrook and Fischel adopt this argument in CORPORATE LAW, *supra* note 2, at 168.

is in doubt. The efficiency thesis's portrayal of contracts written at a firm's "beginning" is inconsistent with the presence of costs so high as to swamp the enormous gains Easterbrook and Fischel believe would be associated with passivity.[259] Moreover, the efficiency thesis also predicts that other sources of law efficiently fill in gaps caused by such ex ante contracting costs.[260] However, neither statutory nor judge-made law has filled this gap by strictly enforcing target managers' fiduciary duties, let alone by establishing a rule of pure passivity. Thus, an argument grounded on the high costs of passivity contracts undermines the arguments for the efficiency of corporate charters, statutes, and common law. Prohibitive contracting costs may salvage the passivity thesis, but only at the expense of the efficiency thesis.

The other way to resolve the corporate law paradox (besides emphasizing the high costs of passivity) is to downplay passivity's benefits. However, this saves passivity at the price of its own significance. More important, such an approach still undermines the efficiency thesis. Even if the net benefits of passivity are small, the various sources of law would have failed to incorporate an efficient term. Also, if passivity and outside monitoring reduce agency costs and yet produce little benefit, the importance of agency costs, and thus the book's thesis, is placed in doubt.

In short, the first weakness of the efficiency thesis is that any attempt to resolve its conflict with the passivity thesis necessitates a comparison of passivity's costs and benefits that ultimately weakens the efficiency thesis. Thus, the paradox remains and, even for Easterbrook and Fischel, the thesis does not explain important aspects of corporate law.

The thesis's second, related shortcoming is a failure of prediction: It is one thing for a thesis to be incomplete, another for it to be unpredictably so. The efficiency thesis does not predict which laws are likely to be particularly efficient and which inefficient, and it may therefore be defined at too high a level of generality.[261] Thus, not only are there obvious and important exceptions (state antitakeover laws, the judge-made law allowing managers to "just say no," and charters that allow inefficient resistance), but there is no way to identify other potential exceptions. Moreover, Easterbrook and Fischel give no reason to believe such exceptions are limited to certain classes. Readers may conclude that such important exceptions swallow the general rule.

The third shortcoming follows from the first two: because the efficiency thesis can neither explain nor predict aberrations, its relevance for policymakers

---

259. *Id.* at 204 (arguing that the deviations from pure passivity may cost billions of dollars).

260. *Id.* at 34 (arguing that courts maximize wealth by filling gaps in contract with terms to which the parties would have agreed); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1433 (1989).

261. *Cf.* Bebchuk, *Limits of State Competition*, *supra* note 112; ROBERTA ROMANO, COMPETITION FOR CORPORATE CHARTERS AND THE LESSON OF TAKEOVER STATUTES (Yale Law School Program in Civil Liability: Center for Studies in Law, Economics, and Public Policy Working Paper No. 152, 1992).

is limited. Because the thesis admits an unspecified range of significant exceptions, the efficiency of a wide variety of laws is in question. And once the efficiency of particular rules is up for grabs, the efficiency thesis, by itself, cannot sort among the rules, separating efficient from inefficient alternatives. Imagine a Delaware state judge or legislator trying to make law more efficient. It is unclear how the efficiency thesis would help the effort. Should there be more regulation or less? The thesis itself does not rule out either: if corporate charters are so costly that efficient terms are left out of the contract, many new laws may be called for—or not. And what *sorts* of laws should the legislator adopt? Perhaps the terms for corporate governance should be enabling only because those terms "do not impose costs on strangers to the contracts."[262] Yet, terms of corporate governance also affect the returns to investor monitoring and thus impose costs on third parties. Perhaps any term that affects monitoring should be mandatory.[263] Moreover, faced with theoretical uncertainty, the policymaker cannot simply look to the actions of large firms to decide which rules to adopt—many of the largest firms have adopted apparently inefficient rules that allow them to resist takeovers. In short, while the efficiency thesis may warn policymakers that Delaware's revenues will decrease if inefficient laws are passed, it does not help them distinguish efficient from inefficient proposals. Thus, the thesis is unable to offer concrete prescriptions for reform.[264] Even if the efficiency thesis is completely accurate, we are left, as we were in its absence, trying to "answer[] difficult questions about the effectiveness of different devices."[265]

As a related point, with respect to the relevance of the efficiency thesis, Easterbrook and Fischel's work appears laced with a subtle irony. They reject academic theories as irrelevant to the economic structure of corporate law, but not *The Economic Structure of Corporate Law*. Their work is itself an academic theory and in turn dependent on other academic theories—in particular, the efficient capital market hypothesis and the decidedly theoretical project of determining contractual terms in the hypothetical world of perfect information and no transaction costs. Thus, their rejection of academic theory is itself a product of academic theory. Moreover, according to their own efficiency thesis, academic work matters very little—the evolutionary pressures are everything. Ironically, if Easterbrook and Fischel consider the thesis relevant and the book important, they cast doubt on their efficiency thesis.[266] Any relevance is

262. CORPORATE LAW, *supra* note 2, at 6-7.

263. *Id.* at 170-71.

264. This lack of order and hierarchy follows naturally from the collapse of fundamental paradox. Yeats made this same observation in somewhat more elegant fashion. Describing the effects of the realization that the accepted notions of God were deeply paradoxical, Yeats wrote: "Things fall apart, the center cannot hold/Mere anarchy is loosed upon the world." YEATS, *supra* note 33, at 187.

265. CORPORATE LAW, *supra* note 2, at 14.

266. This paradox is similar to that faced by determinists who argue passionately with those who believe in free will: if determinism is true, argument and individual initiative are fruitless and appeals to truth

purchased at the price of its accuracy. Therefore, although we predict the book will have great impact, this will be a mixed blessing to its authors.

Part I attempted to demonstrate that, in light of the corporate law paradox and the failure of the efficiency thesis to explain, predict, and prescribe, the present structure of corporate law is due only limited deference. Part II made the complementary point that sometimes efficiency can be obtained only by restructuring corporate law. We have argued that a liability rule can encourage efficient results even when policy proposals turn on unanswered empirical questions. Ours represents the second response to paradox and unanswered empirical questions, in contrast to that of Easterbrook and Fischel. We believe that corporate law scholars can profitably attempt to devise legal rules that encourage efficiency in the face of empirical uncertainty, as well as the resolution of such uncertainty.

---

irrelevant—an implication inconsistent with the emotional intensity of such discussions.