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Poison Pills: Recent Negative Economic Effects Justify Repealing the Related Legislation and Increasing Shareholder Ownership Rights

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POISON PILLS: RECENT NEGATIVE ECONOMIC EFFECTS JUSTIFY REPEALING THE RELATED LEGISLATION AND INCREASING SHAREHOLDER OWNERSHIP RIGHTS

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I. INTRODUCTION

The hostile takeover regulatory regime has evolved in response to proxy

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contests and tender offers.[1] Due to a lack of federal interest, states (mainly Delaware) have stepped in to provide rules of the game for this area of corporate law.[2] Delaware mainly focuses on fiduciary doctrines and standards of review.[3]

The regulatory regime evolved to create a merger doctrine, which allows Board of Directors (Boards) to fend off unwelcomed suitors by implementing procedures that make takeover attempts costly; i.e., they were allowed to deploy "poison pills."[4] These pills have proven their ability to negatively impact market participants by shielding inept and corrupt leaders in huge companies like Enron, WorldCom, and Countrywide.[5] The downfall of these companies negatively affected stakeholders and resulted in significant unemployment.[6] The necessary solution is to repeal poison pill legislation.

In essence, the poison pill provides boards with too much control. Boards can deny shareholders access to fair offers.[7] They can also adopt poison pills quickly without shareholder approval.[8] Boards have the ability to repel acquirers by making the acquisition too costly. They use the poison pill to dilute acquisition efforts and increase the time it takes to acquire a company by replacing a board.[9] As such, poison pill legislation should be replaced with statutes that allow shareholders to entertain bids for their company's acquisition without having the board of directors determine whether the shareholders can review these offers.

Boards can also utilize the pill to increase costs by using it as a bargaining tool to obtain excessive compensation packages.[10] Although this

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[1] John Armour et al., *The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework*, 52 HARV. INT'L L.J. 219, 239–40 (2011).

[2] *Id.* at 241–42.

[3] *Id.* at 241–46.

[4] *Id.* Generally, a poison pill defense maneuver can consist of boards issuing stock rights to all shareholders, except the hostile bidder, to purchase additional shares at 2-for-1 pricing, thus diluting the raider's capability. *Id.*

[5] *See* KATALINA M. BIANCO, THE SUBPRIME LENDING CRISIS: CAUSES AND EFFECTS OF THE MORTGAGE MELTDOWN 6–15 (CCH 2008), http://business.cch.com/bankingfinance/focus/news/Subprime_WP_rev.pdf; s*ee also The 10 Worst Corporate Accounting Scandals of All Time*, ACCOUNTING-DEGREE.COM, http://www.accounting-degree.org/scandals/ (last visited Mar. 30, 2014).

[6] BIANCO, *supra* note 5.

[7] Sang Yop Kang, *Transplanting a Poison Pill to Controlling Shareholder Regimes—Why It Is So Difficult*, 33 NW. J. INT'L L. & BUS. 619, 622 (2013).

[8] STEPHEN M. BAINBRIDGE, CORPORATE LAW 379 (Foundation Press 2d ed. 2009).

[9] Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 858 (1993).

[10] Lucian A. Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 908 (2002).

move has enabled mergers to move forward by making hostile bids friendlier,[11] it comes at a cost.[12] It also rewards bad performance connected with the underperforming target.[13]

Digging deeper into the problem, the regulatory regime is tied to politicians who craft underlying regulations.[14] Politicians, burdened with an interest in maintaining the power associated with their office, may favor the interests of corporations that make huge political donations compared to the general public, whose donations are far smaller. Politicians, as agents of the general public, should owe shareholders a duty of loyalty.[15] This could open the door to shareholders being able to entertain fair offers without intrusive board oversight.

Importantly, shareholders have the right to sell their shares.[16] This right should be protected,[17] and directors should not be able to interfere with it.[18] As such, legislators should reconsider statutes authorizing poison pills and repeal them.

This Note progresses as follows: Part II discusses how the hostile takeover regime developed. This section provides a brief history, including a hostile takeover overview and an explanation of Delaware fiduciary doctrines. The section also provides a glimpse of the negative impact poison pills have on market participants by describing the tension between key players and recent adverse activity. Part III provides an analysis of poison pill ramifications and why these shareholder rights plans should be repealed. It proceeds by arguing that corporate boards have too much control. This section ties control to executive compensation and the board's ability to influence legislation through political donations. Part III also provides a remedy related to statutory regimes and shareholders' right to vote. Finally, Part IV provides the conclusion that poison pill legislation should be repealed because it typically limits shareholder property rights by allowing company board of directors to decide whether the

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[11] *See* Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 899–900 (2002).

[12] *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 6–7 (Harvard Univ. Press, 2004).

[13] *Id.*

[14] Robert G. Natelson, *The Government as Fiduciary: A Practical Demonstration From the Reign of Trajan*, 35 U. RICH. L. REV. 191, 211–32 (2001).

[15] *Id.*

[16] *See* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 413–24 (2006).

[17] *Id.* at 450.

[18] Julian Velasco, *Taking Shareholder Rights Seriously*, 41 U.C. DAVIS L. REV. 605, 672 (2007).

shareholders can vote to accept or deny offers for their shares. Legislatures should adjust statutory regimes to respect shareholder's ownership rights to the extent that they are allowed to sell their shares without having boards as gatekeepers.

II. BACKGROUND

A. Brief History of Hostile Takeovers and Related Regulations

The hostile takeover regulatory regime has evolved in response to strategies utilized to acquire corporate control, mainly proxy contests and tender offers. Where the federal government has left a gap, states have stepped in to provide the regulatory guidance to assess takeover activities.[19] This guidance is rooted in fiduciary duties and standards.[20]

1. Hostile Takeover Overview

Prior to 1960, the primary means for affecting a hostile takeover was the proxy contest.[21] The proxy contest was mainly regulated by the Securities Exchange Act of 1934.[22] State courts addressed lawsuits focused on unethical behavior of target company boards.[23] Beginning in the mid-1960s, the (cash) tender offer was a preferred investment vehicle for acquiring a company.[24] Due to the abusive nature of this tactic, Congress passed the Williams Act of 1968,[25] which imposed important disclosure and procedure requirements for tender offers.[26] However, the Williams Act failed to regulate unethical target board defenses.[27] In response to the lack of interest of Congress, federal and state agencies, and the Supreme Court, Delaware was thrust into the forefront and began to develop the fundamental regime for this area of corporate law in

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[19] Armour et al., *supra* note 1, at 241–47.
[20] *Id.*
[21] Armour et al., *supra* note 1.
[22] *See* Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78n (2010); Solicitation of Proxies, 17 C.F.R. § 240.14a (2010).
[23] Armour et al., *supra* note 1, at 240.
[24] *Id.*
[25] Securities Exchange Act of 1934, Pub. L. No. 90-439, 82 Stat. 454, 455–56 (codified as amended at 15 U.S.C. §§ 78m–78n (2006)). Raiders made high-priced tender offers to shareholders on a "first-come first-served" basis. *See* Armour et al., *supra* note 1, at 241–42. This tactic intimidated shareholders into selling their shares. *Id.* The tactic also prevented target company boards from defending against hostile attempts. *Id.*
[26] Armour et al., *supra* note 1, at 241.
[27] *Id.* at 241.

1985.[28] It is within this framework that the laws regulating board conduct originated and continues to evolve.[29]

2. New Delaware Fiduciary Doctrines

At this time, the federal government lacked interest in regulating board responses to takeover measures.[30] As Delaware was (and continues to be) the primary state of incorporation for most public companies, it was forced to develop rules to address unethical board responses to unwelcomed bids.[31] In *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court decided that a target board has the fiduciary duty and power to protect shareholders from hostile bidders deemed to be a threat to company and shareholder interests and to take measures proportionate to the threat.[32]

The Delaware Supreme Court also developed entirely new standards of review, the "intermediate standards," between 1985 and 1988.[33] The *Blasius Industries v. Atlas Corp.* ("*Blasius*") standard requires that boards show "compelling justification" for actions deemed intentional with regards to interfering with shareholders' right to vote for an alternative board.[34] The *Blasius* court devised this standard to address the poison pill defense.[35] In *Moran v. Household International Inc.*, the court upheld the "pre-planned" use of the poison pill.[36] As a result, the poison pill became the favored defense mechanism in the United States.[37]

B. Negative Impact on Market Participants

As with any process, the hostile takeover regulatory regime created

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[28] *Id.* at 241–42.
[29] *Id.*
[30] *Id.* The SEC also had little interest in regulating board tactics, such as the poison pill. *Id.* Additionally, the Supreme Court "essentially sidelined federal judges and state legislatures with respect to such corporate governance matters." *Id.*
[31] *Id.* at 241–42.
[32] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954–55 (Del. 1985).
[33] Armour et al., *supra* note 1, at 246.
[34] Blasius Indus. v. Atlas Corp., 564 A.2d 651, 652 (Del. Ch. 1988). *Blasius* is still good law, as it was recently cited in a current Delaware case. *See* Kallick v. Sandridge Energy, Inc., 68 A.3d 242, 258 (Del. Ch. 2013).
[35] Armour et al., *supra* note 1, at 246.
[36] Moran v. Household Int'l Inc., 500 A.2d 1346, 1350 (Del. 1985). The court noted that "pre-planning for the contingency of a hostile takeover might reduce the risk that, under the pressure of a takeover bid, management will fail to exercise reasonable judgment." *Id.*
[37] Armour et al., *supra* note 1, at 246.

results as it evolved. This section will show some of the tensions that developed during this regime's early evolutionary period. This section will then go a step further to help the reader understand this area of corporate law by tying recent negative market results to it. The recent negative activity fuels support to the idea that the current hostile takeover regulatory regime should be repealed.

1. Tension Between the Raiders and the Business Roundtable

While the statutory regime developed, key players such as the corporate raiders and the Business Roundtable took their positions on opposite sides.[38] Raiders wanted to realize the underlying values of target companies, and shareholders stood to gain because some of this value could have been transferred to the shareholders.[39] However, boards fought against this push by utilizing groups like the Business Roundtable to lobby for big business.[40] The Business Roundtable lobbied Congress in the 1970s and 1980s, claiming that acquisitions were acceptable.[41] However, Michael Milken came along and forced some of these large corporations to succumb to his junk bond financing; this was unacceptable.[42] According to the Roundtable, the big company acquiring the little company was free enterprise; whereas, the little company acquiring the big company was 'un-American.'[43] Even though the Roundtable CEOs owned less than 1/300 of one percent of their companies' outstanding shares, they controlled the company assets, which were worth billions.[44]

Although lobbying at the federal level did not completely satisfy their needs, the Roundtable and its allies continued to pursue their goals at the state

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[38] ROBERT SOBEL, DANGEROUS DREAMERS: THE FINANCIAL INNOVATORS FROM CHARLES MERRILL TO MICHAEL MILKEN 147–48 (John Wiley & Sons, Inc. 1993). The Business Roundtable was a pro-big business lobbying group that served as a liaison between powerful CEOs and Washington politicians who could help pass favorable legislation. *Id.* It was through the efforts of the Secretary of the Treasury and the Federal Reserve Chairman in 1972 that the Business Roundtable came to existence with members from some of the country's largest organizations. *Id.*

[39] *Id.* at 121–35.

[40] *Id.* at 147–48.

[41] *Id.*

[42] *Id.* at 62–63. Michael Milken is a Berkeley educated Wharton MBA. *Id.* Having subscribed to the notion that low-rated, high-risk bonds could generate higher yields than their counterparts, Michael Milken changed the finance industry by attracting investors to junk bonds. *Id.* at 64–71. He subsequently generated revenue for known and unknown financiers who were interested in acquiring control of corporations. *Id*. at 90–99.

[43] *Id.* at 147–48.

[44] SOBEL, *supra* note 38, at 147–48.

level, where they realized much more success.[45] For instance, in 1987 the Washington state legislature passed SB 6084[46] to protect the biggest company in the state, Boeing, from one of Milken's raiders – T. Boone Pickens.[47] Arizona also passed takeover legislation to protect the Greyhound Bus Corporation from a perceived hostile threat.[48] Similarly, Indiana passed the Indiana Control Share Acquisition Statute to protect CTS Corporation from a takeover by Dynamics Corporation of America.[49] Massachusetts followed the Indiana statute when it enacted legislation[50] to protect Gillette from Revlon, which was controlled by another Milken raider – Ronald Perelman.[51] Moreover, some twenty-one states passed legislation to protect their domiciled companies from junk bond financing.[52]

2. *Recent Negative Impact*

Prior to poison pills, U.S. companies sat on unrealized value. This is evidenced by the fact that pieces of companies were worth more than the whole business enterprise, gains in the billions were reported on investments in the

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[45] *Id.* at 170–71.

[46] Kathryn Wakefield, *Just-in-Time Legislation: Do Corporation-Specific Statutes Violate State Constitutional Prohibitions on Special Legislation*?, 61 U. PITT L. REV. 843, 854 (2000) (citing *New Washington Takeover Law Aimed at Protecting Boeing from Pickens Raid*, SEC. REG. L. REP. (BNA), Aug. 14, 1987, at 1266). This bill stated that Boeing could not engage in any of the significant business transactions with someone trying to acquire the company for five years after that person acquired 10 percent or more of the target corporation's shares without the Board's approval. *Id.*

[47] SOBEL, *supra* note 38, at 136–40. T. Boone Pickens is a renowned corporate raider, having proven himself by running oil companies efficiently and making them profitable. *Id.* He was a "David" amongst Goliaths when he recognized underperforming companies and sought to utilize Milken's war chest of money as a slingshot to take them down by acquiring them. *Id.*

[48] *Id.* at 851 (citing *Arizona Antitakeover Bill Signed During Special Session*, SEC. REG. L. REP. (BNA), July 31, 1987, at 1338). The law limited the voting rights of shares accumulated for a hostile takeover, although the shares could be voted to elect directors or managers. *Id.*

[49] *Id.* at 848. The Indiana Control Share Acquisition Statute prevented hostile acquirers from exercising voting power without approval from a majority of the remaining shareholders. Burns Ind. Code Ann. § 23-1-42-2. The Court upheld this statute in *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987). *Id.*

[50] Wakefield, *supra* note 46, at 851 (citing *Massachusetts Adopts Broad Anti-Takeover Law*, 19 SEC. REG. L. REP. 1099, (1987). The legislation stripped investors acquiring twenty percent or more of a company of voting rights unless the non-management shareholders voted to reinstate those rights. *Id. See also* Arthur R. Pinto, *The Constitution and the Market for Corporate Control: State Takeover Statutes After CTS Corp.*, 29 WM. & MARY L. REV. 699, 714 (1988).

[51] SOBEL, *supra* note 38, at 88. Ron Perelman is another Milken raider, made famous by his acquisition of Revlon and wreaking havoc by, as virtually a no one, taking down large companies. *Id.*

[52] *Id.* at 170–71.

millions, and investors were realizing huge returns of almost fifty percent.[53] In fact, Leveraged Buyout (LBO) investors realized average transactional gains of about ninety-six percent.[54]

When companies sit on unrealized value, other negative consequences can occur. For instance, income disparity can increase when company value is underutilized because the few who control companies are better positioned to exploit market weaknesses.[55] Large corporations are positioned to control output and raise prices.[56] Companies have the power to manufacture consumer demands to the point where the public makes purchases that they do not need.[57] Furthermore, corporate boards and officers become renegades, understanding that they can pay shareholders relatively small amounts of appeasement money while utilizing the lion's share of profits for their own benefit.[58] As such, these profits have gone to the few at the expense of the many.[59]

Additionally, unemployment can occur when companies choose to continue operating inefficiently, rather than subscribing to new ownership and new ideas.[60] Enron was born in 1985 when Houston Gas Company merged with Internorth Inc.[61] While facing the possibility of bankruptcy during its infancy, Enron fought off a hostile takeover attempt.[62] Rather than succumbing to raiders, the company chose to replace its CEO with Jeffrey Skilling.[63] In the

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[53] Tony Ablum & Mary Beth Burgis, *Leveraged Buyouts: The Ever Changing Landscape*, 13 DEPAUL BUS. L.J. 109, 113–14 (2000).

[54] *See* WILLIAM J. CARNEY, MERGERS AND ACQUISITIONS 29–49 (Foundation Press 2nd ed. 2007). "LBO" translates to Leveraged Buyout. SOBEL, *supra* note 38, at 97. This is a way to acquire a company by using its underlying value as equity for financing. *Id.*

[55] John K. Galbraith, *The Affluent Society*, COMMENTARY (Aug. 1, 1958, 12:00 AM), http://www.commentarymagazine.com/article/the-affluent-society-by-john-kenneth-galbraith/. The few who control companies distract less fortunate consumers from moving to upper income brackets by manufacturing wants along with the products to satisfy these wants. *Id.*

[56] Daniel James, *The Modern Corporation and Private Property, by Adolf A. Berle Jr. & Gardiner C. Means,* 8 IND. L.J. 8, 11 (1933) (Book Review), http://www.repository.law.indiana.edu/cgi/viewcontent.cgi?article=5120&context=ilj.

[57] *See generally* Galbraith, *supra* note 55.

[58] *Id.*

[59] *Id.*

[60] *See*, *e.g*., Clinton Free, et al., *Management Controls: The Organizational Fraud Triangle of Leadership, Culture and Control in Enron*, IVEY BUS. J. (July/Aug. 2007), http://iveybusinessjournal.com/topics/the-organization/management-controls-the-organizational-fraud-triangle-of-leadership-culture-and-control-in-enron#.Unb5YflJMdU. Enron's inefficient operations consisted of operating outside of regulatory frameworks. *Id.* As a result, thousands lost their jobs. *Id.*

[61] *Id.*

[62] *Id.*

[63] *Id.* Jeffrey Skilling, as CEO, was instrumental in creating a corporate culture that enabled the subversion of Enron's management controls for preventing fraudulent practices. *Id.*

end, Enron failed, over 4,000 employees lost their jobs and pensions, and Skilling went to jail.[64]

WorldCom provides another example of a negative effect of the poison pill. WorldCom renewed its poison pill during the spring of 2002.[65] The company reported adopting the measure to protect shareholders from someone shortchanging them by offering a low price for a WorldCom that was extremely undervalued.[66] Mind you, WorldCom's stock appeared to be in a free fall because, having traded for $64.50 about three years previously, it was trading for less than $10.[67] Stock price factors in to the market's perception of the effectiveness of company management in terms of maximizing value.[68] The drop in WorldCom's stock price suggests that, comparatively, the market did not sanction the business acumen of WorldCom's leadership.[69] As such, the management team was busy re-deploying the poison pill while the market probably preferred that WorldCom protect itself from its current leadership.

Generally, companies deploy poison pills to protect shareholder value.[70] Poison pills work by making hostile attempts too expensive when acquirers have to purchase additional shares to make up for the dilution the pill creates in their existing shares.[71] However, who protects company shareholders from management and boards that lack business acumen? Who will help the shareholder avoid having to wait multiple years to replace leaders who do not ensure that the company recognize and capitalize on necessary synergies? Moreover, who will ensure the viability of the company, when current leaders fail, in terms of its ability to generate finances necessary to procure resources and efficiently cut costs needed for growth and value maximization? Importantly, who protects the existing company from leaders who make up for the lack of business acumen with fraud? The effects of fraud oftentimes extend beyond the company to other stakeholders, including the general public.[72]

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[64] William W. Bratton, *Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders?: Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1277 (2002).

[65] Shawn Young, *WorldCom, Its Shares Swooning, Renews Expired Poison-Pill Plan*, WALL ST. J., http://www.wsj.com/articles/SB1015800932650408240 (last updated Mar. 11, 2002, 12:01 AM).

[66] *Id.*

[67] *Id.*

[68] *See Why Do Companies Care About Their Stock Prices?*, INVESTOPEDIA, http://www.investopedia.com/articles/basics/03/020703.asp (last visited Mar. 31, 2014).

[69] *See id.*

[70] Jennifer Mears, *Companies Turn to 'Poison Pills'*, NETWORK WORLD, Mar. 18, 2002, at 64 [hereinafter Mears].

[71] *Id.*

[72] *See The 10 Worst Corporate Accounting Scandals of All Time*, *supra* note 5.

The fact of the matter is that "poison pill[s] protect[] existing management."[73] As noted earlier, WorldCom renewed its pill during the winter of 2002.[74] By the summer solstice, a massive accounting fraud was discovered at the company.[75] Whereas the stock was trading at around $65 about two years earlier, and about $10 three months earlier, by the summer it traded at 21 cents as a direct result of the uncovered fraud.[76] The pill had the effect of insulating management who were a direct threat to the company and by extension, shareholder value.[77]

WorldCom's CEO, Bernie Ebbers, was convicted for his role in the corporate fraud.[78] WorldCom's fraud was the biggest in the current wave, which included those associated with companies such as Enron and Adelphia.[79] The fraud consisted of an "accounting slight-of-hand," whereby expenses for capital maintenance were recorded as capital (asset) expenditures.[80] This practice enabled WorldCom to manage industry reported cash flows and profits by conveniently spreading costs over multiple reporting periods.[81] While the company enjoyed the benefits of the pill, i.e., protection from someone who might offer a low price for a WorldCom that was extremely undervalued, WorldCom leadership was busy utilizing accounting fraud practices which inflated assets and profits by as much as $11 billion and $3.8 billion respectively.[82] It took only five quarters to accomplish this feat.[83] More to the point, it took five quarters to commit fraud resulting in 30,000 lost jobs and $180 billion in investor losses.[84] Ebbers was convicted for his role in the fraud and sentenced to twenty-five years in prison, while having previously justified using the poison pill to protect shareholders from someone shortchanging them.[85]

Similarly, Countrywide was a huge subprime lender during the period

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[73] Mears, *supra* note 70 (alterations in original).

[74] Young, *supra* note 65.

[75] *Massive Accounting Fraud Fells WorldCom*, TIME (June 26, 2002), http://content.time.com/time/business/article/0,8599,266287,00.html.

[76] *Id.*

[77] *See id.*

[78] Krysten Crawford, *Ebbers Gets 25 Years*, CNN MONEY (Sept. 23, 2005, 7:42 AM), http://money.cnn.com/2005/07/13/news/newsmakers/ebbers_sentence/.

[79] *Id.*

[80] *Massive Accounting Fraud Fells WorldCom*, *supra* note 75.

[81] *Id.*

[82] *The 10 Worst Corporate Accounting Scandals of All Time*, *supra* note 5.

[83] *Massive Accounting Fraud Fells WorldCom*, *supra* note 75.

[84] *The 10 Worst Corporate Accounting Scandals of All Time*, *supra* note 5.

[85] *Massive Accounting Fraud Fells WorldCom*, *supra* note 75.

that led up to the recent economic downturn.[86] Eager for profits, lenders like Countrywide accommodated an increase in mortgage demand by taking risks and creating ways to lend money to less than credit-worthy borrowers.[87] These borrowers were able to increase consumer spending by refinancing and pulling equity out of over-priced properties.[88]

However, the market corrected itself and consumer spending decreased because mortgage payment amounts increased faster than home values.[89] The effects hit cities, like Detroit, where auto sales decreased, unemployment increased, and housing values decreased.[90] Unemployed Detroit homeowners, faced with rising mortgage payments on properties that were decreasing in value, experienced foreclosure.[91] Today, this translates into blight.[92] The corporation law regulatory regime facilitated the Detroit blight by enabling companies like Countrywide to be shielded by poison pills and promulgate lending policies that allowed consumers to qualify for mortgages that would inevitably result in foreclosure.[93] Countrywide had a poison pill in place as late as 2008, when it was forced to allow a friendly acquisition by Bank of America.[94] If the poison pill was not in place, an owner with a better management team could have avoided the need to push the boundaries and contribute to one of the worst recessions this country has experienced.[95]

Boards of directors at companies like WorldCom have the power to refuse to relinquish control of underperforming companies.[96] This power is derived from poison pill legislation. Stakeholders should not be asked to act as if target board of directors will not place their interests above the stakeholder interests. Should we also believe that boards will not use company resources to support politicians who vote for poison pill legislation? The analysis section will examine why poison pill legislation should be repealed and replaced with

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[86] *See* BIANCO, *supra* note 5, at 8.
[87] *Id.*
[88] *Id.*
[89] *Id.*
[90] *Id.*
[91] *Id.*
[92] Douglas Jamiel, *Detroit's Dan Gilbert: Henry Ford or Henry Potter?*, TRUTHOUT (Dec. 22, 2013, 9:40 AM), http://www.truth-out.org/opinion/item/20604-detroits-dan-gilbert-henry-ford-or-henry-potter.
[93] BIANCO, *supra* note 5.
[94] *Bill Miller: Can't Decide on Countrywide*, CNN MONEY (Feb. 12, 2008, 2:06 PM), http://money.cnn.com/2008/02/12/markets/bill_miller/.
[95] *See* Bianco, *supra* note 5, at 6–8. Some say that a rise in unregulated lenders who peddled suprime loan products such as adjustable rate, interest-only, and "stated income" mortgages contributed to the recent recession. *Id.*
[96] Young, *supra* note 65.

statutes that ensure shareholder control over their share ownership rights without having target board of directors make a decision about whether the shareholders can have a vote and exercise those rights.

III. ANALYSIS

The hostile takeover regulatory regime has evolved to a point where recent negative market results can be tied to it. In furthering the notion that this regulatory regime should be repealed, the next section gets to the root of the problem by highlighting the abundance of control target company board of directors have and the ways they use it to help politicians, sympathetic to their cause, entrench themselves. Additionally, this section provides the following adequately robust solution: Repeal current anti-takeover statutes and replace them with shareholder-friendly legislation that favors shareholders being able to vote on whether to entertain bids for the company without having a board of directors determine whether they should have this vote.

A. Poison Pills Provide Boards Too Much Control

Developments over the recent business cycle indicate that the hostile takeover regulatory regime can facilitate significant economic downside results because maneuvers such as poison pill deployment enable corporate boards to neglect broad-based shareholder interests.[97] Poison pills provide boards with too much control. These pills allow boards to hold companies hostage and command compensation packages in exchange for relinquishing corporate control. Boards can also utilize company resources to lobby for favorable legislation, at the expense of shareholder owners. Legislatures should adjust statutory regimes to respect shareholders' ownership rights to the extent that they are allowed to sell their shares without having boards as gatekeepers.

Justification for poison pills is rooted in the need for corporations to have independent boards.[98] However, outside directors may be independent in form but not so in fact.[99] Outside directors often have personal ties to executives.[100]

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[97] *The Great Recession*, ST. WORKING AM., http://stateofworkingamerica.org/great-recession/ (last visited Mar. 26, 2014). Triggered by an $8 trillion dollar housing bubble, the Great Recession brought the United States a tremendous loss of wealth and a sharp cutback in consumer spending, with high unemployment being the obvious result. *Id.*

[98] *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949–50 (Del. 1985); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1348 (Del. 1985).

[99] *See, e.g.*, *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 921–30 (Del. Ch. 2003). An outside director is one deemed independent, i.e., one who does not have a material interest in the company. *Id.* In this case, a member of a special litigation committee was a Stanford professor

For instance, eleven of the fourteen Enron board members were (supposedly) independent at the time of its scandal.[101]

Around the early 1990s, the Delaware pill[102] evolved to allow boards to refuse reasonably fair offers, i.e., they could "just say no."[103] Boards can adopt poison pills relatively quickly, without shareholders' approval, by a board resolution within the few hours it takes to convene and hold a vote.[104] As such, every (Delaware) corporation has a latent shareholders' rights plan/poison pill, although it might not have surfaced at the time of a hostile bid.[105]

Target boards even went as far as to try and block shareholders' ballot box recourse by creating poison pill offshoots such as the "dead pan provision," which only allowed incumbent board members or their chosen successors to redeem a poison pill.[106] The Delaware Chancery court invalidated this provision, noting that it precluded proxy contests, which were used by Raiders to elect a new board who would redeem the poison pill.[107] In *Quickturn Design Systems, Inc. v. Shapiro*, the slow hand pill, which was non-redeemable for six months, was also invalidated.[108] Still, the hostile takeover wars have succumb to the "impermeable" poison pill because proxy fights and tender offers are inefficient in terms of the time it takes to replace opposing

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who had taught one of the directors under investigation, while other directors had contributed to Stanford. *Id.*

[100] *Id.*

[101] *See* Frederick Tung, *The Puzzle of Independent Directors: New Learning*, 91 B.U. L. REV. 1175, 1176 (2011); Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002).

[102] BAINBRIDGE, *supra* note 8.

[103] Kang, *supra* note 7. In *Paramount Communications, Inc. v. Time, Inc.*, Time's board refused a premium, non-coercive offer, and the Delaware Supreme Court upheld this refusal stating that the Unocal test allowed the board to substitute its judgment for the shareholders' "ignorance or mistaken belief." Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1153 (Del. 1989).

[104] BAINBRIDGE, *supra* note 8; *see also* John Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 286–87 (2000).

[105] Coates IV, *supra* note 104, at 288–89. This is because the *Moran* court made pills legitimate. *Id.*

[106] Jack B. Jacobs, *Implementing Japan's New Anti-Takeover Defense Guidelines—Part 1: Some Lessons from Delaware's Experience in Crafting Fair Takeover Rules*, 2 N.Y.U. J.L. & BUS. 323, 348 (2006).

[107] Carmody v. Toll Bros, Inc., 723 A.2d 1180, 1184 (Del. Ch. 1998). A newly elected board favoring the deal would be precluded from acting. Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP. L. 1, 17 (2003).

[108] Quickturn Design Sys. v. Shapiro, 721 A.2d 1281, 1291 (Del. 1998). A slow hand pill is a mechanism that precludes newly elected boards from disabling a poison pill for a set period of time, such as six months. *Id.*

board members and the associated exorbitant costs.[109]

1. Executive Compensation

When the potential for significant personal benefit is high, hostile bids incentivize management to use poison pills to bargain with.[110] Raiders realized that boards were holding target companies hostage, so they adjusted their approach and sweetened the deal for directors by including an increase in executive compensation in the package.[111] The increase in executive compensation caused merger and acquisition (M&A) activity to grow stronger because deals were friendlier with boards receiving a premium for relinquishing control of their companies.[112]

Executive compensation evolved to convert the pill from a "just say no" remedy to a negotiation primer for moving deals forward.[113] In effect, executive compensation has sustained the market for corporate control.[114] Managers from companies with strong anti-takeover defenses tend to have higher compensation.[115] Extrapolated CEO pay reflects this phenomenon.[116] In the early 1990s, CEOs of large companies in the United States made 140 times what corresponding workers made; whereas, by 2003 that number increased to 500 times more than what corresponding workers made.[117]

Executive compensation works mainly because it aligns management's interest with those of the shareholders.[118] However, in the corporate control context, executive compensation can be excessive when it is used to reward relinquishing control rather than incentivizing better performance.[119] Board members can command excessive executive compensation to relinquish control of a company despite the fact that these very board members are typically the reason for the low stock prices that made their companies targets.[120] Michael

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[109] Grundfest, *supra* note 9.
[110] Bebchuk et al., *supra* note 10.
[111] Kahan & Rock, *supra* note 11.
[112] *Id.*
[113] Kang, *supra* note 7, at 662.
[114] *Id.*
[115] *See* Kenneth A. Borokhovich, Kelly R. Brunarski, & Robert Parrino, *CEO Contracting and Antitakeover Amendments*, 52 J. FIN. 1495, 1515 (1997).
[116] Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1619 n.16 (2004).
[117] *Id.*
[118] Kang, *supra* note 7, at 625–26. Executive compensation allows for management to receive something other than being let go. *Id.*
[119] BEBCHUK & FRIED, *supra* note 12.
[120] Kang, *supra* note 7, at 665.

Ovitz[121] serves as an example for amounts companies can pay to transfer control, as he received approximately $130 million despite serving only 25% of his employment contract period and despite alleged disappointing performance.[122]

2. *Politicians as Fiduciaries*

Boards also have too much control when it comes to their control of company resources. Boards can utilize these resources to further their own interests at the expense of shareholders. Courts in the United States have ruled against poison pills; however, state legislatures have responded by sanctioning them.[123] The U.S. Constitution supports the notion that political power comes from the people.[124] The people grant political power to their elected agents to govern over their interests and bind them legally.[125] These elected representatives owe a fiduciary duty of loyalty to the principals[126] who elected them because this is where the power derived.[127] However, this duty is not normally "operationalized" in the form of being judicially enforceable.[128]

As in corporate law, the courts should enforce the politician's fiduciary duty of loyalty.[129] This approach provides principals a remedy when agent politicians engage in self-dealing.[130] It also promotes a better alignment between the principal and agent's interests.[131]

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[121] Brehm v. Eisner (*In re* Litigation of Walt Disney Company Derivative), 906 A.2d 27, 35 (Del. Ch. 2006). Michael Ovitz entered into a five-year agreement to serve as president of The Walt Disney Company but only served in that capacity for fourteen months due to concerns about his performance. *Id.*

[122] *Id.* The court acknowledged that the facts supported the notion that Ovitz's performance was subpar and that Ovitz lacked commitment because he performed services for other companies even though his employment contract required him to devote his time fully to Disney. Brehm v. Eisner, 746 A.2d 244, 265 (Del. 2000).

[123] CHARLES R. T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 787 (Aspen Publishers 5th ed. 2006). States authorize poison pills *ex ante*, i.e., without having responded to a court ruling. *Id.*

[124] D. Theodore Rave, *Politicians as Fiduciaries*, 126 HARV. L. REV. 671, 712 (2013); *see also* U.S. CONST. pmbl. ("We the People . . . do ordain and establish . . . .").

[125] Rave, *supra* note 124.

[126] This article utilizes the following convention: Principals are parties that vote for politicians; whereas, agents are political representatives.

[127] Natelson, *supra* note 14.

[128] Rave, *supra* note 124, at 707. "Operationalized" refers to the lack of processes in place to make politicians' fiduciary duties judicially enforceable. *Id.*

[129] *Id.*

[130] *Id.*

[131] *Id.*

The similarities between corporate and political governance are obvious. Mainly, both are represented by principals who elect agents that can prefer their own interests over those of the principal.[132] To be sure, the agents from each group make decisions that can bind the principals; whereas, these agents do not necessarily have to follow the instructions of the majority of the shareholders or voting public.[133] In fact, the agency problem is more problematic when it comes to politics because, unlike corporations where a shareholder can sell their shares, voters in political primaries lack ways for exiting their agency relationship.[134]

Representatives are burdened with an interest in retaining the power that comes with their elected positions, and this dynamic can present a conflict with the interests of the general public. Where there is a potential conflict of interest, the public should not trust agents to act in their interest. As such, representatives should not be trusted to act in the interest of the people.[135] An example is where politicians vote to raise their own salaries.[136] They cannot do so without affecting the general public.[137]

More importantly, agents may utilize their control over lawmaking to entrench themselves.[138] They may favor the interest of their constituent corporate donors rather than the general public to stay rooted in their elected positions.[139] Boards can control corporate political donations, and they have the ability to funnel money to representatives who pass legislation that can give the boards power over corporate control decisions.[140]

Political lawmaking regarding poison pill legislation presents a conflict of interest.[141] Public opinion may diverge when it comes to favoring whether politicians should represent the interest of their constituents versus those of the general public.[142] It is likely, however, that the consensus would not sanction politicians acting mainly in their own interest.[143]

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[132] *Id.* at 706.
[133] *See*, *e.g.*, Cook v. Gralike, 531 U.S. 510, 519–22 (2001) (noting the delineation of power of the people and politicians).
[134] *See* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY 104–05 (Harvard Univ. Press 1970).
[135] Rave, *supra* note 124, at 715.
[136] *Id.* at 714.
[137] *Id.*
[138] *Id.*
[139] *Id.*
[140] *Id.*
[141] Rave, *supra* note 124, at 714.
[142] *Id.* at 719.
[143] *Id.*

B. Remedying the Problem: Reeling in the Power

As the problem exists in the legislation, the solution lies there as well. Legislators can adjust poison pill legislation to protect shareholder ownership rights by repealing anti-takeover statutes and replacing them with a regulatory regime which guarantees shareholders' right to vote on offers for their shares. In their approach, legislators can eliminate board veto power, establishing a shareholder approval safety valve. Boards would be able to vote under this regime on attempts to acquire their companies; however, shareholders should have the final say.

1. Statutory Regimes

Most states have statutory regimes that enable boards to utilize poison pills that prevent unwanted bids.[144] Boards combine poison pills with staggered boards[145] to create powerful veto power.[146] Eliminating board veto power could provide a safe harbor against management conflicts of interest, especially where there is a shareholder approval safety valve.[147] Otherwise, the absence of the disciplinary affect of shareholder review could allow managers to shirk their responsibility.[148] Moreover, veto power enables managers to perform poorly and retain corporate control or receive exorbitant compensation on their way out.[149] Importantly, veto power could provide boards the authority to block offers that are beneficial to shareholders.[150]

The current regulatory regime implies mandated deference because boards make the choice regarding whether a bid moves forward.[151] This does not mean that boards can obtain better results than shareholders themselves.[152] Boards should be allowed to negotiate, just like attorneys who bargain for their clients, provided that shareholders are able to make the final decision.

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[144] Bebchuk et al., *supra* note 10.

[145] *Id.* at 893–99. A staggered board is one such that groups of board members go up for re-election, often in elections years apart, rather than all of them in one year. *Id.* Shareholders have to wait to have an opportunity to replace board members who block hostile bidders they favor under the staggered board structure because unfavorable board members may not be up for reelection until several years in the future. *Id.*

[146] *Id.*

[147] Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 978 (2002).

[148] *Id.* at 1012.

[149] *Id.* at 993–94.

[150] *Id.* at 1000.

[151] *Id.* at 978.

[152] *Id.*

Historical data supports this view.[153] For example, research indicates that managers will sacrifice shareholder value in exchange for better treatment of managers.[154] Additionally, on average, shareholders experience a loss when management defeats offers.[155] Protections from anti-takeover statutes cause managerial slack[156] as well as poor operating performance.[157] In addition, poison pills can add between 6% and 12% to the cost of an acquisition,[158] and this can be significant because the extra cost could drive away an offer that shareholders would otherwise welcome.

2. *Shareholder Voting*

The main antitakeover prescription consists of a poison pill combined with a staggered board.[159] This "cocktail" does not allow shareholders to vote on a board's decisions to reject bids.[160] One commentator believes that "[n]either the finance literature nor the norms of corporate law support vesting such unbalanced power in the hands of the board."[161] The main inquiry should be who is more likely to make better decisions – target boards and their related consultants or the judiciary, the market, or shareholders.[162]

Economists recognize that the market typically includes in the model for valuing a company, its future cash flows, and the propensity for management to make investment decisions.[163] Arguably, a lack of independence exists where management judges its own capabilities. However, a "bilateral decision structure," which allows shareholders to vote on board takeover decisions, synthesizes these two approaches because neither can unilaterally act on a

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[153] Bebchuk, *supra* note 147, at 979.
[154] *Id.*
[155] *See* James F. Cotter & Marc Zenner, *How Managerial Wealth Affects the Tender Offer Process*, 35 J. FIN. ECON. 63, 86 (1994).
[156] *See generally* Marianne Bertrand & Sendhil Mullinathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON 535 (1999).
[157] *See* Paul A. Gompers, Joy L. Ishii, & Andrew Metrick, *Corporate Governance and Equity Prices* (Nat'l Bureau of Econ. Research, Working Paper No. 8449, 2001), http://papers.nber.org/papers/w8449.pdf (last visited Jan. 13, 2014).
[158] William J. Carney & Leonard A. Silverstein, *The Illusory Protections of the Poison Pill*, 79 NOTRE DAME L. REV. 179, 181 (2003).
[159] Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search For Hidden Value*, 96 NW. U. L. REV. 521, 561 (2002).
[160] *Id.*
[161] *Id.*
[162] *Id.* at 553.
[163] *Id.*

bid.[164] In fact, shareholder voting provides additional oversight for preventing bad board decisions.[165]

One commentator argues that Delaware General Corporation Law section 141[166] promulgates that "the corporation's business and affairs are 'managed by or under the direction of a board of directors.'"[167] As such, boards typically make corporate decisions, while shareholders have no right to initiate action; rather, they are relegated to the role of reviewing few board actions.[168]

Still, shareholders have rights, including the right to vote and to sell their shares.[169] Of these two rights, shareholders typically hold the right to sell shares to be of more value.[170] The right to sell shares should be protected just as the right to vote is protected.[171] Taken seriously, directors should not be able to interfere with this right.[172]

Antitakeover statutes are fundamentally misguided and thus should be repealed.[173] This legislation was based on a misguided premise; i.e., that hostile takeovers are bad.[174] Public opinion suggests that (hostile) takeovers that resulted in companies selling off pieces destroyed jobs.[175] However, the business divisions were typically sold to new owners, and job losses were attributable to the market.[176] On the other hand, these takeovers generated huge returns, forcing companies to access unrealized value by improving efficiencies.[177] As such, legislators should reconsider these statutes and repeal them.[178]

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[164] *See generally* Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. CORP. L. 583 (1994).

[165] Black & Kraakman, *supra* note 159, at 560.

[166] Del. Code Ann. tit. 8, §141(a) (2001).

[167] Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 603 (2006).

[168] *Id.*

[169] Velasco, *supra* note 16.

[170] Velasco, *supra* note 18.

[171] *Id.* at 627.

[172] *Id.*

[173] *Id.* at 675.

[174] *See generally* Dale Arthur Oesterle, *Revisiting the Anti-Takeover Fervor of the '80s Through the Letters of Warren Buffett: Current Acquisition Practice is Clogged By Legal Flotsam from the Decade*, 19 CARDOZO L. REV. 565 (1997).

[175] *Id.*

[176] *See id.* at 607–08.

[177] Velasco, *supra* note 18, at 676.

[178] *Id.* at 675.

IV. CONCLUSION

Poison pill legislation should be repealed. Politicians should enact statutes which allow shareholders the right to vote on transferring the company to a bidder regardless of board of director approval. The hostile takeover regulatory regime has evolved. As the state of incorporation of most national corporations, Delaware has filled the void where the federal government has been reluctant to participate with legislation that affects key players in the market for corporate control.[179] Of these players, poison pills favor company board of directors.[180] However, this favoritism is at the expense of the shareholder's fundamental right to sell their shares. The favoritism has also allowed inept and fraudulent company leaders to negatively affect key stakeholders, including the general public.[181]

In essence, poison pill legislation provides company boards too much control; i.e., they can demand exorbitant compensation packages in exchange for relinquishing corporate control[182] and use company assets to influence politicians to enact favorable legislation.[183] Legislators owe shareholders a duty of loyalty.[184] In order to salvage shareholder's right to entertain fair offers and sell their shares, politicians should reconsider statutes authorizing poison pills and repeal them. Politicians should simultaneously enact shareholder-friendly legislation, i.e., statutes which allow shareholders the right to vote and entertain bids for their company even if the company board disagrees.

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[179] *See, e.g.*, Del. Code Ann. tit. 8, § 141.
[180] Mears, *supra* note 70.
[181] *The 10 Worst Corporate Accounting Scandals of All Time*, *supra* note 5.
[182] Kahan & Rock, *supra* note 11.
[183] Rave, *supra* note 124, at 715.
[184] Natelson, *supra* note 14.