THE CASE FOR MANAGERIAL SIGNALING IN ADJUDICATING HOSTILE TAKEOVERS

Nitzan Shilon[*]

* Assistant Professor, Peking University School of Transnational Law. Most of the work was done while I was an S.J.D. candidate and a John M. Olin Corporate Governance Fellow in Law and Economics, Harvard Law School. I am grateful to Lucian Bebchuk, Jesse Fried, Charles Yablon, Phillip Curry, the participants of the annual conference of the American Law and Economics Association, the Canadian Law and

Abstract

This paper argues that the law should allow a target board to signal its belief that certain unsolicited bids to take over the corporation are undesirable. A target board may signal this opposition by committing, if the bid fails, to purchase—and hold for a specified time—a certain amount of the target corporation's stock at the bid price. Courts that perceive the signal credible should give it substantial weight when deciding whether to allow the board to use defensive tactics, including a "poison pill," to fend off a hostile takeover. Even when courts do not allow defensive tactics, shareholders may still be persuaded by the signal and be authorized to fend off the bid. I construct a game theoretical model to show that the suggested mechanism separates loyal managers from disloyal managers and credibly transmits valuable private information from boards to courts and shareholders. I further show that the proposed signaling mechanism will improve managerial ex-ante incentives to maximize firm value and reduce agency costs. Finally, I suggest a framework for a legal reform in Delaware to implement my proposed mechanism.

Keywords: Game Theory and Bargaining Theory, Mergers, Acquisitions, Restructuring, Corporate Governance, Payout Policy, Corporation and Securities Law.
JEL Classification: C70, G34, G35, K22.
© Nitzan Shilon 2016. All rights reserved.

TABLE OF CONTENTS

Section	Page
INTRODUCTION………………………………………………………..............................	1
I. MANAGERIAL AGENCY COSTS AND THE IMPORTANCE OF TAKEOVERS…......	6
II. THE PROBLEMS WITH TAKEOVERS………………………………….…...……….	xx
III. THE DELAWARE APPROACH TO SOLVE THE PROBLEMS WITH TAKEOVERS...	xx
A. *Substantive Coercion Threat under the Unocal-Unitrin Intermediate Scrutiny Standard*……………………….……......................................	xx
B. *Recent Lawmaking Decisions Expand Substantive Coercion*………..	xx
C. *The Problems with Substantive Coercion*…………………........................	xx
IV. THE CASE FOR MANAGERIAL SIGNALING…………………………….…………	xx
A. *The Suggested Mechanism [INCLUDE SIGNALING TO COURTS]*……………………………….....……...	xx xx
B. *Implementation in Current Delaware Doctrine*….………………..…...	xx
C. *Removing Legal Obstacles to Allow Managerial Signaling*…………..	xx
D. *Solving Credibility Issues and Promoting Informational Efficiency*....	xx
E. *Reducing Ex-ante Agency Costs*……………..…..……………...……	xx
F. *Encouraging Long-Term Focus*…………………………………………..……	xx
G. *Promoting Fairness*…………………………………………………………	xx
H. *Signaling Bylaws*…………………………………………………………….	xx
I. *Superiority of Managerial Signaling to Other Solutions*………………	xx
V. CONCLUSION……………………………………………………………….	xx
APPENDIX A………………………………………………………………..	xx

INTRODUCTION

How should the law protect shareholders and public corporations from opportunistic hostile bidders? In the last forty years, raiders have been developing techniques to take over corporations despite board opposition while target boards have been mastering sophisticated defenses to fend off such attacks.[1] Investment bankers and law firms have been paid lucrative fees to assist parties on both sides of the battle. Lawmakers and courts, in response, have developed a rich takeover doctrine, aiming to identify threats that legitimize target boards' efforts to protect their corporations from unsolicited bidders. This issue has become increasingly important as, over the past year, shareholder activism has reached new heights[2] and hostile deal making worldwide has reached record levels of hundreds of billions of dollars annually.[3]

The ongoing debate regarding hostile takeovers has focused on who—boards or shareholders—should have the power to decide when a hostile bid is opportunistic and hence should be fended off. To some scholars, shareholders do not need boards to protect them from opportunistic bidders; giving target boards the power to block unsolicited takeovers allows incumbents to entrench themselves at the expense of shareholders.[4] To other scholars, however, a board veto is necessary to protect the corporation from opportunistic bidders and maximize its long-term value.[5]

While there is wide agreement that this debate is important for corporate governance,[6] scholars have paid little attention to tailor-made solutions in which the

---

[1] One notable defensive tactics is the so-called poison pill. The term *poison pill* describes a family of "shareholder rights" that are triggered by an event such as a hostile tender offer or the accumulation of voting stock above a designated threshold (usually 15 percent of outstanding stock) by an unfriendly buyer. When triggered, poison pills provide target shareholders (other than the hostile bidder) with rights to purchase additional shares or to sell shares to the target on very attractive terms. These rights impose severe economic penalties on the hostile acquirer and usually also dilute the voting power of the acquirer's existing stake in the firm.
The array of takeover defenses includes charter amendments that require supermajorities (i.e., votes of 70 percent or even 80 percent of shareholders) to approve a merger; dual-class restructurings that, by creating two classes of stock, concentrate voting control with management; litigation against the hostile suitor (usually alleging violations of antitrust and securities laws); and purchase of the hostile bidder's foothold stock at a premium to end the takeover threat (so-called green-mail payments). Although these particular defenses often are effective at delaying the hostile bidder, they rarely are enough to keep a target company independent. The poison pill, however, is a "show-stopper," and so I focus on it.

[2] Last year activists launched more campaigns in the United States than in any other year on record, according to FactSet [ ]. They secured corporate board seats in 127 of those campaigns, far surpassing the previous year's record of 107.

[3] *See* Maureen Farrell, *The Wall Street Journal, Deal Making Has Never Been This Hostile*, WALL ST. J., June 23, 2015, at 3.

[4] *See, e.g.,* Frank Easterbrook and Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); also *see* Lucian A. Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002); also *see* Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981).

[5] *See* Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW 101 (1979).

[6] *See* William T. Allen, Jack B. Jacobs, and Leo E. Strine, *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067 (2002) (suggesting that the "great takeover

power to decide takeovers is granted according to the specific circumstances of each case. This is surprising because the Delaware courts, where most U.S. takeovers are decided, developed a doctrine that focuses on a case-by-case determination of the legitimacy of board defensive tactics.[7] The aim of this article is to fill this gap by suggesting a mechanism that courts could deploy to improve the credibility of their decision making in takeover cases.

The core challenge in takeover situations is that while boards have a significant conflict of interest with shareholders, they also have a greater insight than shareholders into the value of their firms and hence into the desirability of the takeover bids. A board is in conflict with its firm's shareholders because if a takeover succeeds, the board is likely to be removed. At the same time, the board generally possesses superior insight because it has exclusive access to important information related to the value of the firm[8] as well as the professional expertise to process such information; this insight puts it in the best position to evaluate the firm's future value should the takeover fail. Furthermore, it is likely that, at least in some cases, there are frictions of various sorts that could limit the board's capacity to credibly convey this inside understanding to shareholders.

Currently, the Delaware courts try to gauge the legitimacy of defensive tactics by requiring target boards to have a committee of independent directors determine whether the bid price is too low and whether shareholders are likely to mistakenly accept it.[9] However, even if independent directors are legally disinterested, their de facto disinterestedness is doubtful.[10] Moreover, target boards often support their positions in court by providing paid opinions made by bankers and lawyers, whose subjective assumptions are hard to attack.

Under the reform proposed in this article, target boards should be allowed to signal against the desirability of a hostile bid. In particular, they may do this by committing, if the bid fails, to purchase—and hold for a specified time—a certain amount of the target firm's stock at the bid price.[11] Alternatively, target boards should be allowed to commit to converting the equivalent economic value of their future stock-based compensation into at-the-bid-price target shares and to hold those shares for the same period of time. Courts would be required to give substantial weight to such a managerial signal. In particular, they would be compelled to allow managers to use proportional

debate" reflects a fundamental struggle between competing models of the corporation and corporate governance).

[7] *See, e.g.,* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989); see also Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); see also Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del.1995) (recognizing three types of threats that might justify proportionate defensive tactics on a case-by-case basis: structural coercion, substantive coercion, and opportunity loss).

[8] *See* Robert Charles Clark, *Corporate Law* (1986), 1.2.4 and 3.1.1.

[9] This is the concept of "substantive coercion." *See* Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1153 (Del.1990).

[10] *See* Kelvin Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 997-1008 (1988).

[11] In 2002, Professor Bebchuk suggested that only shareholders will have the power to decide unsolicited takeovers and proposed that managers should be allowed to signal the shareholders their beliefs against an unsolicited offer in a way that is similar to what I suggest here. *See* Lucian Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 UNI. CHI. L. REV. 973 (2002).

defensive tactics, including a "poison pill," to fend off hostile takeovers if the signal is credible.

In deciding whether the signal is credible, courts would avoid the need to gauge the long-term value of the target firm in case the bid fails and the firm stays independent. Instead, they would use a two-step inquiry. First, they would set the credible signaling level. They would do so by considering a hypothetical target board that believes that the value of the firm, if it stays independent, is equal to the bid price. They would determine what that theoretical board's maximum willingness to signal would be[12] if it had the case-specific factors of the actual target board, such as the gap between the bid price and the stock price, the board's private benefits of control, the costs associated with loss of diversification to incumbents' stock as a result of exercising the signal, and the size of the board's golden parachute.[13] Second, they would determine whether the actual board signal is credible. In particular, when the signaling level chosen by the actual board equals or exceeds the hypothetical board's maximum willingness to signal, courts would determine the signal to be credible and thus give it considerable weight when deciding whether to allow the target board to use proportionate defensive tactics to fend off the hostile bid.

My proposed reform is primarily addressed to courts because I expect it to work better in the legal system than in a shareholder veto regime, where only shareholders decide whether to accept an unsolicited bid. Because of shareholder collective action problems, it would be hard for dispersed shareholders in public corporations to gather the information necessary to enter the proper values for the variables of the formula I propose. Moreover, shareholder expertise is in investing rather than in evaluating business decisions.[14] Courts, in contrast, do not suffer from collective action problems and have sufficient expertise to perform this task. Also, even if shareholders have enough information or expertise to decide whether a managerial signal is credible, merger arbitrageurs, who seek quick short-term profits, often flock to target corporations and can distort shareholder choice.[15] Still, should courts not perceive a board signal credible and not allow incumbents to fend off the bidder, my proposed scheme would enable the shareholders to decide whether to accept the bid, and management willingness to signal at a certain level or lack thereof might help them make that decision.

My proposed mechanism, if adopted, might have dramatically changed the results of the recent three-way pharmaceutical takeover fight involving Teva, the world's biggest

---

[12] Unlike the independent value of the firm, the determinants of such maximum willingness to signal are verifiable and can be conveyed credibly.

[13] A golden parachute is an agreement between a company and an executive specifying that the executive will receive certain significant benefits if employment is terminated as a result of a change in control.

[14] *See* Eugene Fama & Michael Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301 (1983).

[15] A merger arbitrage, or a risk arbitrage strategy, is possible in both a cash merger and in a stock merger. In the former, the arbitrageur buys the target's stock, which typically trades below the purchase price, and makes a gain if the acquirer ultimately buys the stock. In a stock merger, the arbitrageur takes a long position in the stock of the target and a corresponding short position in the stock of the acquirer. In both cases, the arbitrageur hopes to make a short-term profit if the merger is consummated and runs the risk of incurring a significant loss if it is not. Therefore, the arbitrageur might choose to distort target shareholder choice and thus reap short-term arbitrage profits rather than maximize the long-term value of the target shareholders.

generic drug company; Mylan, the world's second-largest generic and specialty pharmaceuticals company; and Perrigo, an American international manufacturer of private-label, over-the-counter pharmaceuticals. In this record-value battle, Mylan's board fought Teva's hostile advances in an unusually acrimonious manner and prevented Mylan stockholders from deciding whether to accept a significant premium on their stock price.[16] Had the Mylan board been required to signal its opposition to the $82 per share Teva bid in order to use its aggressive defensive tactics, it probably would have found that action to be too costly and might have preferred to enter into a negotiated deal with Teva, thereby changing the outcome.

While fiercely vetoing Teva's bid, Mylan took advantage of weak anti-takeover statutes in Ireland to extend an unsolicited tender offer to Perrigo shareholders against the will of Perrigo's board, just to be rejected by the shareholders.[17] If the Perrigo board could have used defensive tactics and justified them by committing to buy some Perrigo shares at Mylan's low bid price, it could have prevented Mylan from approaching its shareholders, thereby saving itself the disruption and its shareholders the uncertainty involved in Mylan's attack.

My proposed signaling mechanism significantly improves the informational efficiency of takeover adjudication. I use a game theoretical model to show that the mechanism would transmit valuable private information about the desirability of the bid from target boards, who are best positioned to know whether an unsolicited bid stands to better long-term shareholder welfare, to courts and shareholders. At the same time, it would resolve the conflict of interest between incumbents and shareholders by putting boards in the shoes of long-term shareholders and requiring them to credibly signal their genuine professional stand.

Importantly, managerial ex-ante incentives to reduce agency costs and maximize long-term shareholder value would increase. This is because a board would be more reluctant to pursue actions that do not maximize shareholder value. Such actions would likely reduce stock price and, hence, increase the probability of a takeover. Under the proposed reform, when a takeover bid is launched, a board would no longer be able to use defensive tactics and justify them in court with shareholder money. Instead, it would have to choose between giving in to the takeover or incurring the personal costs of signaling.

The proposed reform would also improve a board's ability to focus on the long term. A major concern for firms today is that markets do not understand the positive long-term effects of actions that sacrifice short-term profits.[18] Firms that prefer long term

---

[16] *See* Steven Davidoff Solomon, *Mylan's Dutch Takeover Defense Is in Nasdaq's Hands*, N.Y. TIMES DEALBOOK, June 11, 2015; see also Charley Grant *Mylan Is Too Big a Pill for Teva*, WALL ST. J., Apr. 21, 2015.

[17] *See* Jen Wieczner, *Why Mylan Just Lost The Largest Hostile Takeover Battle Ever,* FORTUNE, Nov. 13, 2015 (explaining that, because Perrigo inverted to Ireland, where anti-takeover laws are weak, Mylan could bypass Perrigo's CEO and board and make an offer directly to the company's shareholders—something that could not happen in the United States.).

[18] *See, e.g.,* William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 660 (2010), at 702 ("[W]here institutional fund managers benchmark portfolios by reference to quarterly earnings per share (EPS), sensitivity to stock market reactions implies a focus on quarterly earnings numbers. Once management prioritizes meeting the market's EPS expectations, investments that enhance long-term value but impair near-term earnings may be delayed or [forgone]"); see also Colin Mayer, FIRM COMMITMENT: WHY THE CORPORATION IS FAILING US AND HOW TO RESTORE

to short term, the argument goes, are exposed to temporary stock price decline and hence to opportunistic bidders. The proposed reform would allow boards to defend their long-term strategy and fend off myopic raiders by signaling their beliefs about the high long-term value of their firms. When long-term value is high, the cost of signaling is low because the at-the-bid price at which shares must be purchased is lower than the firm's expected high long-term value. This allows managers to cheaply defend the corporate bastion against short-term pressures.

Moreover, the proposed reform should promote fairness because it would expose disloyal directors. Loyal directors—those who fend off hostile bids only if such opposition protects long-term shareholder value—would likely incur significantly lower signaling costs than disloyal ones and so their chances of remaining in office in the face of a hostile bid are significantly higher. Because managers are expected to receive some ex-ante compensation for their possible future signaling costs, the reform would probably improve the welfare of loyal managers at the expense of the disloyal ones.

Because firms and loyal directors can reap significant benefits from passing the signaling test, I expect that some firms would respond to the proposed reform by adopting bylaws that regulate the process for board signaling. For example, firms may set up internal bylaw procedures for independent committees of directors to determine the threshold of credible board signaling. Perhaps proxy advisors, such as Institutional Shareholder Services (ISS), would reward firms for having such bylaw provisions. Such mechanisms would improve the adjudication process because they would further ensure the credibility of information provided to courts.

Finally, the proposed mechanism is superior to other mechanisms that have been implemented so far—in particular, the golden parachute arrangement. Rather than aligning directors' incentives with shareholders by giving directors a fixed bonus if they agree to leave the firm when a hostile bid is launched, my mechanism seeks to impose on directors a variable cost that they will incur if they do not leave. Because the signaling mechanism involves a cost to incumbents instead of the salient payment they would get with their golden parachutes, shareholders should prefer it. Moreover, unlike with golden parachutes, signaling cost is variable, and managers are better off leaving the firm only when their signaling costs are high—for example, when the value of the firm, if it stays independent, is low compared to the bid price. Therefore, the mechanism is expected to encourage only those takeovers that are expected to increase long-term firm value. Finally, rather than receiving a guaranteed cushion upon removal, disloyal directors who do not maximize shareholder value would be expected to incur high signaling costs or

---

TRUST IN IT (2013), at 200 ("It [is] . . .increasingly difficult for directors to do anything other than reflect what is perceived to be in the immediate interests of their most influential, frequently short-term shareholders," impairing directors' ability to act in the long-term interest of the corporation, and "[t]he calls for greater shareholder activism only . . . reinforce this"). See also Aspen Inst., Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management 4 (2009), available at http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/overcome_short_state0909_0.pdf (worrying that many financial intermediaries holding retirement and college savings of Americans "engage in . . .activism in pursuit of short-term financial objectives at the expense of long-term performance and careful analysis of fundamental risk").

give in to the takeover. Therefore, the signaling mechanism, unlike the golden parachute,[19] does not weaken market discipline for directors.

The paper continues as follows. Chapter I reviews the problem of managerial agency costs in U.S. corporations and the importance of takeovers to curb these costs. Chapter II discusses the various problems with allowing a full-fledged market for takeovers. Chapter III reviews the Delaware approach in solving the significant problems that takeovers pose. Chapter IV presents the case for managerial signaling in adjudicating hostile takeovers, discusses its benefits, and addresses potential objections. Finally, I conclude.

[CHAPTERS TO FOLLOW]

[19] Firms that adopt a golden parachute experience a reduction in their industry-adjusted Tobin's Q, as well as negative abnormal stock returns, which indicates an ex-ante reduction in market discipline. See Lucian Bebchuk, Alma Cohen and Charles Wang, *Golden Parachutes and the Wealth of Shareholders*, 25 J. CORP. FIN. 140 (2014).