

Images of Organizations and Interfirm Externalities: A Comment on Prof. Rubin

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INTRODUCTION

In his article, Prof. Rubin argues against a single conception of the organization, such as the classic nexus of contracts view, and calls for a richer perception. He presents four different models of organizational behavior and suggests that each must be considered before regulators intervene in corporate affairs. Without such broad consideration, his argument goes, officials may misunderstand the origins of corporate conduct and misperceive the consequences of regulation. Interestingly, Rubin analyzes the organization as a stand-alone entity, a weakness shared by most scholars who adhere to the nexus of contracts approach. In my comment, I highlight the importance of analyzing interactions among firms in order to understand corporate behavior and to craft effective regulation.¹

I build upon Rubin's analysis to show that each view of the corporation may be further enriched by carefully considering firm interactions. In this sense, my analysis backs Rubin's call to broaden the common perception of the corporation. To some extent, however, the consideration of interactions among firms may also undermine Rubin's project. This is because certain corporate behavior that seems inexplicable under the nexus of contracts approach may seem fully rational when we consider interactions among

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1 Edward L. Rubin, *Images of Organizations and Consequences of Regulation*, 6 *Theoretical Inquiries L.* 347 (2005).

firms. Therefore, the search for a richer perception of the corporation to solve corporate conundrums may be excessive and unwarranted.

To illustrate this point, the comment concentrates on a current high-profile corporate mystery. Recent studies have revealed that IPO-stage firms diverge in their attitudes toward antitakeover charter provisions ("ATPs").² While the charters of some companies are replete with such legal shields, they do not exist in other companies. This finding, coupled with the absence of any relevant distinguishing factors among these new issuers, has puzzled corporate law scholars. Rich perceptions of the corporation such as those highlighted by Rubin may help solve this mystery, and I show that the literature already contains hints in this direction. My comment further demonstrates that interaction among corporations, under each of the rich perceptions of the corporate entity, may provide an even better explanation for the examined phenomenon. Nevertheless, I question these explanations as perhaps excessive. Indeed, even the "thinnest" and most commonly-used model of the corporation, the nexus of contracts approach, may provide an adequate answer for the mystery once interactions among firms are brought into the equation.

The analysis begins with a brief account of the four different organizational models that Rubin discusses: the nexus of contracts approach; the behavioral model of the corporation; the corporation as a culture; and the corporation as an organism or system. In Part II, I present the mystery of the divergence in ATP practice among IPO-stage firms and show how the behavioral account of the corporation or the view of the corporation as a culture may explain such corporate behavior. Part III shows that even the nexus of contracts approach may solve the conundrum if interactions among firms are seriously considered. Part IV addresses the corporation as an organism model and demonstrates how it supports the analysis of firm interaction in the framework of the nexus of contracts approach. I conclude with some broader lessons that can be drawn from the example of corporate ATP practices.

2 See John C. Coates, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 Cal. L. Rev. 1301 (2001); Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value?*, 17 J.L. Econ. & Org. 83 (2001); Laura C. Field & Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, 57 J. Fin. 1857 (2002).

I. A BRIEF ACCOUNT OF FOUR MODELS OF THE CORPORATION

Rubin urges considering four different organizational models before analyzing corporate behavior or regulation design. The first is the view of the corporation (or, more broadly, the organization) as a nexus of contracts,³ the dominant image of the corporation, which is commonly adopted by economists and law and economics scholars. It views the corporation as a legal fiction that allows corporate constituencies, i.e., shareholders, managers, employees, suppliers, etc., to reach contractual relationships efficiently. The organization is, therefore, nothing more than the hub of consensual interaction. Under this view, organizational law is in fact a subset of contract law, which is customized for a particular subset of social interactions. And since this organizational model was developed by traditional economists, it naturally assumes that all corporate players are fully rational and self-interested.⁴

The second approach to organizational behavior is termed the behavioral model of the corporation.⁵ This model builds upon theories of bounded rationality⁶ that are currently accepted by many economists, although they are little applied by corporate law scholars.⁷ Corporate constituencies, just as any other individuals, suffer from cognitive illusions. Moreover, some of these biases, which may lead to sub-optimal behavior, may be typical of the corporate structure since it is built as a hierarchy. One example of a typical corporate bias is the goal displacement phenomenon. Subordinates wrongfully displace the goals of the organization in the framework of the tasks they are charged with, pursuing these tasks by all means even if they conflict with the objectives of the organization. This cognitive bias, as well as many other documented biases, may shed light on corporate behavior.

The third model of organizational behavior Rubin presents is the view of

3 Rubin, *supra* note 1, at 349.

4 The economists that are usually credited with the nexus of contracts concept are Jensen & Meckling. Michael C. Jensen & William H. Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structures*, 4 J. Fin. Econ. 305, 305-60 (1976).

5 Rubin terms this model "the corporation as a decision-making hierarchy." Ruben, *supra* note 1, at 352.

6 The field of bounded rationality is often identified with the work of Kahneman & Tversky. See, e.g., Daniel Kahneman & Amos Tversky, *Prospects Theory: An Analysis of Decision Under Risk*, 47 *Econometrica* 263, 263-91 (1979).

7 For one exception, see Sharon Hannes, *Corporate Stagnation: Discussion and Reform Proposal*, 30 J. Corp. L. (forthcoming 2005) (describing the tendency of corporate governance structures to preserve the status quo).

the corporation as a culture.⁸ Under this model, human behavior in general and the behavior of corporate players in particular are not simply a rational, self-interested response to different circumstances they contend with. People also (or maybe even primarily) act in accordance with the surrounding culture or social norms. And organizations (although not to the same extent as other social institutions) may develop their own cultures or codes of behavior. Therefore, differences in corporate behavior may be attributed to differences in corporate cultures. The corporate culture is path-dependent and may originate from many sources, such as the nature of the founders, the place of incorporation, etc. Therefore, it is possible that two corporations that seem quite familiar on the surface may have different sets of social norms and thus react differently in identical situations.

The final model is the view of the corporation as an organism. The central point of this model is that the metaphor of the corporation as an organism is useful because scholars have found that social systems, such as the corporation, share some of the characteristics of biological systems. For instance, biological systems attempt to maintain their equilibrium or stable state (i.e., their output, internal structure, and boundaries) in a changing environment. Social systems such as the corporation may also try to maintain their levels of production and preserve their structures in the face of a changing reality (which possibly requires the opposite response of a change in output or the breakup of the corporate structure). Note that, to some extent, the view of the corporation as an organism is the opposite of the nexus of contracts approach, since the focus of the former is on characteristics of the corporation as a whole. In contrast, the nexus of contracts approach focuses on the incentives of the individuals behind the corporation and ignores the corporate locus.

II. IMAGES OF ORGANIZATIONS AND ANTITAKEOVER PROVISIONS

This part of the comment presents the puzzle of divergent patterns of behavior among IPO-stage firms with regard to ATP decisions. It then considers how two of the richer perceptions of the organization presented by Rubin — the behavioral approach and the corporation as a culture — may shed light on this peculiar phenomenon. Furthermore, an advanced approach to such conceptions of the corporation, one that takes into account

8 Rubin presents this as the fourth model. Rubin, *supra* note 1, at 361.

interactions among corporations, may have further explanatory power in this respect.

A. The Puzzle of ATP-Adoption by IPO-Stage Firms

The defining feature of a hostile takeover is the fact that the board of directors of the target firm opposes the proposed transaction. Thus, the bidder must directly convince the target's shareholders to tender their shares and approve the transfer of control. Following the 1980s takeover boom,⁹ innovative legal devices (which were upheld by judicial precedents) enabled a target's board of directors to block bids by means of a variety of legal shields.¹⁰ Shrewd attorneys advised corporate boards to adopt shareholder rights plans, notoriously known as "poison pills."¹¹ Under the terms of such plans, the purchase of a significant portion of stock without the board of directors' approval triggers valuable rights for incumbent shareholders at the expense of the buyer.¹² Consequently, the board of directors in effect acquires the discretion to prevent the transfer of control by purchase of stock.¹³

However, even with a poison pill in place, a bidder can solicit the votes of shareholders in order to replace an incumbent board.¹⁴ If the solicitation succeeds, the newly elected directors can remove the poison pill,

9 The merger wave of the 1980s was so fierce that an unbelievable 30% of the Fortune 500 companies were subject to takeover bids during this decade. See Gerald Davis & Suzanne Stout, *Organization Theory and the Market for Corporate Control: A Dynamic Analysis of the Characteristics of Large Takeover Targets, 1980-90*, 37 *Admin. Sci. Q.* 605, 608 (1992).

10 See the seminal case of *Moran v. Household Int'l Inc.*, 500 A.2d 1346 (Del. 1985).

11 These developments troubled even those scholars who maintain that state law competition generally leads to efficient results. See Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 *Nw. U. L. Rev.* 913 (1982); Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 *Fordham L. Rev.* 843, 856-59 (1993).

12 Poison pills typically allow the incumbent shareholders to buy the acquirer's stock (so-called "flip-over" poison pills) or the target's stock (so-called "flip-in" poison pills) at a substantially discounted price. A flip-over poison pill is generally a far less potent defense than a poison pill with a flip-in provision. See Ronald J. Gilson & Bernard S. Black, *The Law and Finance of Corporate Acquisitions* 747 (2d ed. 1998).

13 For the terms of a standard poison pill, see Wachtell, Lipton, Rosen & Katz, *The Share Purchase Rights Plan*, reprinted in *id.* at 4.

14 One exception is the so-called "dead-hand" poison pill, which managers use to try to undermine the effectiveness of a proxy contest. A dead-hand poison pill limits the ability to redeem the poison pill to those directors who were members of the

since "poison pills can be removed by a board of directors as easily as they can be installed."¹⁵ Once the pill is removed, the bidder may proceed to purchase the target's stock. In this manner, the voting process may overcome the harsh effects of the poison pill and allow the bidder to finalize the hostile takeover.¹⁶ There are, however, tactics that can interfere with and delay the replacement of a board of directors. For instance, although Delaware law requires that every board member be elected annually, a charter provision may establish staggered elections, so that only a third of the board is replaced or reelected

board at the time of the pill's adoption. These were prohibited by the Delaware Chancery Court in *Carmody v. Toll Brothers*, 723 A.2d 1180 (Del. Ch. 1998), at least if the articles of incorporation do not include authorization for their adoption, *id.* at 1191. The Delaware Supreme Court adopted a similar approach in *Quickturn Systems Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

15 John C. Coates, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. Corp. L. 837, 852 (1999).

16 In reality, when the bidder solicits the shareholders' votes to circumvent a poison pill, she must also create a credible commitment to purchase the stock after she has captured the board. This commitment is necessary to assure the shareholders that the bidder will not pursue her own agenda at the expense of the shareholders after she has prevailed in the vote. Moreover, the committed purchase price serves as a signal to the shareholders in evaluating the quality of the bid. The market mechanism to allow for such a commitment is a contingent tender offer that is held in conjunction with the proxy fight for the board. In short, this is a simultaneous offer to replace the management of the company and buy its shares. See Harold Mulherin & Annette Poulsen, *Proxy Contests and Corporate Change: Implications for Shareholders Wealth*, 47 J. Fin. Econ. 279, 286 (1998). First, the shareholders are presented with an offer and decide whether or not to tender their stock. However, the tender offer is not consummated at this stage, so as not to trigger the poison pill. Thereafter, and if enough shares are tendered, the shareholders vote for the board, and if the bidder prevails, the contingent tender offer is automatically triggered. The poison pill is immediately lifted, and the target's stock changes hands for the previously specified price. A joint tender offer and proxy contest are thus structured to overcome the board's disinclination to the transaction. This joint vote and tender offer also assist shareholders to overcome strategic tendering that could hurt the entire shareholder group. Thus, it prevents coercive bids that are designed to pressure and absorb shareholders' value. See Lucian A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 Harv. L. Rev. 1695 (1985); Lucian A. Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, 12 Del. J. Corp. L. 911 (1987). Finally, uninformed shareholders may find it hard to decide whether to vote for or against their own managerial team. The offered price compared to the pre-bid price of the firm's stock may help the shareholders reach a decision. A more accurate explanation may be found in Lucian Bebchuk & Oliver Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control* (Dec. 2001) (NBER Working Paper Series No. W8633), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=293246.

each year.¹⁷ However, gaining control of a third of the board obviously does not get one a majority, and thus gaining control of a staggered board requires victory in at least two voting battles.¹⁸

Unlike poison pills, which are implemented by the board, ATPs that delay the replacement of the board beyond a legal default, such as a staggered board charter provision, ordinarily require shareholder approval in order to be implemented.¹⁹ Alternatively, such ATPs may be installed in the firm's initial charter or during the period when ownership is concentrated, before the initial public offering.²⁰ Some widely acknowledged features of the IPO stage have led researchers to conclude that an analysis of ATP decisions of IPO-stage firms would help determine whether defenses are beneficial or inimical to shareholders.²¹ As noted before, recent empirical studies have revealed that firms differ vastly in the way in which they implement their freedom to adopt ATPs prior to the IPO stage. Many firms adopt different types of ATPs, but

17 See Del. Code. Ann. tit. 8, § 141(d) (1991). There is a possibility of forming a two-tiered staggered board instead of a three-tiered one. However, in practice, the former structure does not provide managers with the benefits of a three-tiered staggered board, and therefore, it is rarely, if ever, witnessed.

18 For background, criticism, and statistics regarding staggered boards, see Investors Responsibility Research Center, *Classified Boards Background Report* (1994). Empirical research by Ambrose & Megginson found that classified boards are associated with a decrease in the likelihood of a firm's acquisition, but that other takeover defenses have no statistically significant effect on acquisition likelihood. See Brent W. Ambrose & William L. Megginson, *The Role of Asset Structure, Ownership Structure, and Takeover Defenses in Determining Acquisition Likelihood*, 27 *J. Fin. & Quantitative Analysis* 575, 575-89 (1992).

19 By the 1990s, the ease with which ATPs were adopted in seasoned firms had disappeared. The increased power and activity of institutional shareholders practically precluded managers from implementing ATPs in such firms. See Daines & Klausner, *supra* note 2, at 84. Consequently, ATPs are either adopted at the IPO stage or else never adopted at all. As phrased by Coates,

After an IPO is complete and ownership dispersed, the takeover defenses of a public company in the U.S. in the 1990's have generally been fixed. Only at the IPO stage does a company continue to have the ability to choose different types and amounts of defenses that will regulate hostile bids for the life of the company.

Coates, *supra* note 2, at 1308.

20 However, in the second half of the 1980s, as illustrated by the work of Karpoff & Danielson, managers easily obtained shareholder consent for various delaying mechanisms. Karpoff & Danielson's empirical work shows that the percentage of antitakeover shields in seasoned firms grew tenfold during this period. See Jonathan M. Karpoff & Morris G. Danielson, *On the Uses of Corporate Governance Provisions*, 4 *J. Corp. Fin.* 347, 354 tbl. 2 (1998).

21 The notion that a firm going public can maximize its value by adopting optimal

many others do not adopt ATPs at all (or else adopt minor defenses). This finding sparked the debate from the 1980s about the welfare implications of ATPs, between commentators who believe that ATPs are beneficial to shareholders and those who believe that ATPs are simply a symptom of inefficient managerial entrenchment.²² One commentator recently presented the challenge to traditional corporate law as follows:

[A]cademics have generally opposed defenses, and practitioners have generally supported them ... Easterbrook and Fischel arguing that directors should respond passively to takeover bids and that courts should presume defenses illegal Lipton argued that hostile bids are disruptive and costly for targets Standing alone, Lipton's position would suggest all companies should adopt defenses prior to an IPO, and Easterbrook & Fischel's position would suggest that no firm should adopt a defense; yet, in reality, many do and many do not.²³

The divergent behavior of IPO-stage firms in relation to ATPs therefore remains a mystery. In the next section, we will see that Rubin's extensive descriptions of the organization may help shed some light on this mystery.

governance structures can be traced to the seminal work of Jensen & Meckling, *supra* note 4. See also Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 4-7 (1991).

22 The debate is summarized at length in Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 *Yale J. on Reg.* 119 (1992). Much of the copious literature deals with the effects of takeovers and ATPs on a variety of corporate actors. The discussion focuses on the influence of new conditions on managers, shareholder wealth (from the perspective of both corporate targets and bidders), employees, hosting communities, consumers, suppliers, government, and society. See, e.g., 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); Frank H. Easterbrook & Daniel R. Fischel, *Takeover Bids, Defensive Tactics, and Shareholders Welfare*, 36 *Bus. Law.* 1733 (1981); Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 *Stan. L. Rev.* 23 (1982); Ronald Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 *Stan. L. Rev.* 51 (1982); Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in *Corporate Takeovers: Causes and Consequences* 33 (Alan Auerbach ed., 1988) (concentrating on the effects of takeovers on employees under the assumption that the corporate raider is likely to breach implicit contracts between the corporate target and its employees); Margaret Blair & Lynn Stout, *A Team Production Theory of Corporate Law*, 85 *Va. L. Rev.* 247 (1999).

23 Coates, *supra* note 2, at 1327-28.

B. ATPs and the Behavioral Approach to the Corporation

Rubin's suggestion to abstract away from the view of the firm (and its constituencies) as a rational player may be helpful in untangling the ATP puzzle. Rubin concentrates on behavioral biases that are related to the fact that the organization is a hierarchy, such as the goal displacement phenomenon. However, some other documented biases should also be accounted for. For instance, Kahan & Klausner, in a paper that has much to contribute to our discussion since it also deals with interactions among firms, referred to several cognitive phenomena that were documented in the field of behavioral psychology to justify the irrational tendency to use standardized terms for corporate law products.²⁴ First, there is evidence of a *status quo bias*: people simply prefer to maintain the prevailing state.²⁵ The second cognitive bias discussed by Kahan & Klausner is the *anchoring bias*.²⁶ This phenomenon is related to the importance of the initial reference point that influences one's judgment. Once an initial reference point is established, it is extremely hard to adjust the anchor.²⁷ In addition to these two biases, there is another bias that applies to the behavior of individuals within groups: the *conformity bias*. Individuals, as well as organizations, are prone to adopting arrangements and views that are considered acceptable by others in their reference group.²⁸

The results of at least one empirical study on ATPs suggest that these cognitive biases and bounded rationality problems play a major role in IPO-stage firms' decisions whether to adopt ATPs. In his study, Coates

24 See Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 Wash. U. L.Q. 347, 359 (1996).

25 See, e.g., William F. Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. Risk & Uncertainty 7 (1988).

26 See Kahan & Klausner, *supra* note 24, at 362.

27 See, e.g., S. Plous, *Thinking the Unthinkable: The Effects of Anchoring on Likelihood Estimates of Nuclear War*, 19 J. Applied Soc. Psych. 67 (1989).

28 The classic laboratory study that showed the potency of the conformity bias was conducted by Salomon Asch. In his experiment, Asch asked members of a group to match lines according to their lengths. All but one of the members of the group were Asch's collaborators, and Asch instructed them how to answer the questions. The experiment asked one group member at a time to match lines of similar lengths. After a few rounds, the collaborators selected pairs of lines that were evidently incorrectly matched. Only 20% of the non-collaborating subjects remained entirely independent. All the rest turned their backs on their own perceptions and went along with the group. See Salomon E. Asch, *Social Psychology* 451-68 (1952).

investigated two samples of IPO firms. The main group of data includes over three hundred IPOs between the years 1991-1992 and is accompanied by smaller control samples for the end of the 1990s. His basic findings follow those of the earlier studies:²⁹ a high degree of variance was found in the defense practices of firms that go public,³⁰ and this variance cannot be explained by the classic literature.

In addition, Coates adopted an innovative approach and measured the market's impact on ATP-adoption for lawyers. He found that ATPs are more common among corporations that hire law firms from a particular group. Because Coates did not find any relevant dissimilarities among the various firms that could explain the divergent practices, he assumed that one group of lawyers simply mislead their clients.³¹

In my opinion, these empirical findings seem to fit the behavioral approach to the organization, which Rubin urges us to consider. The status quo bias, the anchorage bias, and especially the conformity bias may all shed light on firm behavior.

The standard ATP approach of the law firm that accompanies the public offering may very well serve as an anchor and represent the status quo for the new issuer. Since the consequences of ATPs are highly uncertain, it is only natural for the new issuer, who has both limited knowledge in the field as well as perhaps bounded rationality, to adopt the prevailing arrangement. And as far as the issuer knows, the prevailing arrangement is the one usually adopted by its legal counsel.

The conformity bias may also play a salient role in this decision-making process. Coates could not find any special firm characteristic that may explain a corporation's ATP choices, except for the identity of its legal counsel. However, it is quite plausible that the choice of legal counsel may be the product of which lawyers other issuers in the same reference group hire. For instance, an internet startup may hire a lawyer who has served

29 Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value?*, 17 J.L. Econ. & Org. 83 (2001); Laura C. Field & Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, 57 J. Fin. 1857 (2002).

30 Although there is an increased tendency for IPO issuers to adopt ATPs with time. See Coates, *supra* note 2, at 1376-77.

31 Several findings, including the fact that more lawyers now prefer ATPs, led Coates to conclude that the proponents of ATPs were right all along. Coates has launched several attacks on the conventional academic conception that ATPs are harmful and raise agency costs. See John C. Coates, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 Tex. L. Rev. 271 (2000). And as Coates mentions in his papers, he served as a partner in the firm that is credited with the invention of the poison pill. See Coates, *supra* note 2, at 1301 n.1.

similar firms in the past or has served entrepreneurs who went to business school with the entrepreneur in the internet startup or simply because that lawyer has served issuers who are held in high esteem by the managers of the startup. If this is the case, then the conformity bias tells us that the new issuer is likely to adopt the arrangement that was adopted by other issuers in its reference group. In this story, the identity of the lawyer is not the driving force behind ATP choices, but it is helpful to capture the actual missing variable that drives the results, which is membership in a certain reference group of issuers. Under this approach, opting for ATPs is the product of irrational herding, and the path dependency of the process may lead (although not inevitably) to inefficient outcomes, at least for some of the issuers.

C. ATPs and the Corporation as a Culture

The view of the cooperation as a culture, another descriptive model of the organization that Rubin discusses, may also shed light on firm behavior in relation to ATPs. Under this view, one must account for the specific social norms developed within each organization for the acts of such entities to be fully understandable. In a recently-published empirical study, Field & Karpoff may have found traces of the inner social norms of the corporation impacting ATP decisions.

Field & Karpoff investigated over one-thousand firms that went public between 1988 and 1992.³² This is the earliest sample of IPO-stage firms to have been investigated. Like other empirical studies in this field, their principal finding fits the model presented in this comment. Indeed, 53% of the firms sampled had at least one takeover defense, while the rest had refrained from adopting ATPs.³³

Field & Karpoff also found that IPO firms deploy more defenses if their managers enjoy relatively higher compensation and lower equity stakes in the corporation.³⁴ Their interpretation of this finding was that managers who are not well-monitored by non-managerial pre-IPO investors are able to trick such investors by adopting inefficient ATPs when going public. However, the findings of another empirical study, conducted by Daines & Klausner, suggest that Field & Karpoff's interpretation may be flawed. Daines & Klausner

32 See Field & Karpoff, *supra* note 2, at 1858.

33 See *id.* at 1858, 1884.

34 "[T]he probability that an IPO firm has a takeover defense is positively related to managers' compensation and is negatively related to managerial ownership" *Id.* at 1884.

investigated a large control sample of IPO firms with venture capital and professional LBO investors.³⁵ These firms did not have fewer defenses, which undermines the argument that rigorous monitoring leads to fewer defenses.³⁶

There is, however, another possible explanation for the finding that managers who are highly paid and do not hold many shares in the corporation are more likely to adopt ATPs. Highly-paid managers who hold relatively small equity stakes may simply be professional managers, in contrast to the entrepreneurs or the founders of the corporation. And if one believes in the concept of the corporation as a culture, it is fairly possible that the culture of a firm that is run by professional managers is much different than that of a firm that is still being run by its original founders. Professional managers are likely to be more aware and troubled by the future consequences of going public, including the possibility of being ousted by a takeover event, and will therefore try to defend against it. Founders, in contrast, may be less focused on future capital market eventualities, concentrating more on the corporation's current projects. The possibility of being ousted by a takeover event in the future might even seem unrealistic to a founder.

In any case, the point here is not that the difference between a professional manager and a founder-manager is simply one of knowledge and sophistication, but rather it is a matter of business, culture, and norms. A firm run by a professional manager is more likely to cope (and maybe overreact) to capital market concerns than the founder (if she is still in charge), who is more likely to put emphasis on the product market.³⁷ Hence, it is no wonder that managers with the typical characteristics of a professional manager are more likely to adopt takeover defenses. The conclusion is, therefore, that the view of the firm as an entity with a distinct culture may help us understand corporate conduct.

Alongside this explanation, the notion of the firm as a culture may shed even more light on ATP-adoption trends if we consider interaction among firms. If each firm, as Rubin argues, develops its own culture and adheres to certain norms, it is also possible that firms sometimes adhere to the norms of

35 See Daines & Klausner, *supra* note 2, at 93.

36 Daines & Klausner also found in their sample that higher levels of ownership by managers tend to increase the severity of ATPs, which completely contradicts the findings of Field & Karpoff. See *id.* at 109-10. Nevertheless, I shall assume here that Field & Karpoff's results are precise.

37 It is also possible that the founder is more essential to the well-being of the firm than a professional manager, and therefore founders are less often ousted in hostile takeover events.

other firms, those that they consider their cultural leaders. Some corporate behavior, including ATP-adoption, may be explained along these lines.

For instance, Microsoft, which certainly possesses the qualities for becoming a cultural leader for other firms, recently announced two significant changes in its policy. First, Steve Ballmer, Microsoft's CEO, announced on July 8, 2003, that Microsoft will cease to use stock option incentives for employees and will adopt different performance-based incentives.³⁸ Second, on September 12, 2003, the Microsoft Board of Directors announced the adoption of a new dividend policy and that it had doubled the previous dividend rate.³⁹ Before long, many other companies, especially in the high-tech sector, refreshed their policies as well and followed the trend initiated by Microsoft.

It is possible that the corporations that shifted their policies in line with Microsoft's new policy were simply acting rationally. Policies must be kept up to date, and Microsoft's decision may simply be a proper stimulus for such a decision-making process. It is also possible that these other corporations were simply suffering from irrational herding. If corporations are subject to behavioral biases, one cannot trust that the decision to follow Microsoft was a calculated one. But if one subscribes to the view of the firm as a culture, it is also possible that other firms followed Microsoft simply because it is their cultural leader. And from dividend policy and employee compensation plans to ATP trends: it is possible, though I know of no direct evidence to support this claim, that IPO-stage firms simply adhere to the ATP policy of the corporation or corporations with which they share the same (business) culture.

III. INTER-FIRM EXTERNALITIES UNDER THE NEXUS OF CONTRACTS APPROACH

The previous Part showed that Rubin's suggestion to deviate from the thin view of the organization as a nexus of contracts may, indeed, be useful in clarifying the divergence in ATP-adoption by firms. Both the behavioral approach to the organization and the view of the organization as a culture are suitable candidates in this endeavor. Elsewhere, however, I have already suggested that an extended version of the nexus of contracts

38 See Microsoft Telephone Press Conference Regarding Employee Compensation Announcement (July 8, 2003), available at <http://www.microsoft.com/presspass/exec/steve/2003/07-08compensation.asp>.

39 See Microsoft Press Release, Microsoft Increases Annual Dividend to \$0.16 (Sept. 12, 2003); available at <http://www.microsoft.com/presspass/press/2003/sep03/09-12DivPR.asp>.

approach, one that accounts for interaction among firms, may, in itself, solve the ATP variation mystery.⁴⁰ Instead of sacrificing the classic understanding of the organization as a nexus of contracts, we should first reevaluate some firmly-held understandings regarding the takeover phenomenon.

The kernel of my argument is that takeover defenses do not only deter takeover bids, but also divert takeover activity from shielded targets to non-shielded targets. The potential advantage in antitakeover charter provisions, which can guarantee higher premiums to shareholders in the event of a takeover, is eroded by the adoption of defenses by multiple targets. The reason for this is that bidders prefer to buy unshielded targets, all other factors equal, since they are less expensive. Like the increased risk of burglary to one's apartment when a neighbor installs bars on his windows, the likelihood that unshielded targets will endure takeover events grows as the ratio of shielded targets to unshielded targets in the market increases.⁴¹ Unlike the diversion of criminal activity, however, the diversion of takeover activity is beneficial to the target's shareholders.⁴²

The fact that industry rivals can become alternate takeover targets was proven in a recent empirical study showing sharp rises in the stock values of rival firms when an anticipated merger fell apart.⁴³ In deciding whether to make an offer, bidders must weigh the relative functional or business virtues of each of the potential targets against the relative ease or difficulty with which they can be acquired. Since takeover defenses make the acquisition process

40 The discussion in this section and the following section follows my analysis in Sharon Hannes, *A Demand-Side Theory of Antitakeover Defenses* (Aug. 1, 2003) (Berkeley Olin Program in Law & Economics, Working Paper Series, Paper No. 93), available at <http://repositories.cdlib.org/blewp/art93>.

41 See Steven Shavell, *Individual Precautions to Prevent Theft: Private Versus Socially Optimal Behavior*, 11 *Int'l J.L. & Econ.* 123, 126 (1991).

42 This behavior entails a type of externality among potential targets that has heretofore been ignored by the takeover literature. The contemporary literature identified various other externalities, however. See, e.g., Sanford Grossman & Oliver Hart, *One Share, One Vote, and the Market for Corporate Control*, 20 *J. Fin. Econ.* 175 (1988); Lucian A. Bebchuk & Luigi Zingales, *Corporate Ownership Structures: Private Versus Social Optimality* (May 1996) (NBER Working Paper Series No. 5584), available at <http://papers.nber.org/papers/w5584.pdf> (externalities on corporate bidders); Shleifer & Summers, *supra* note 22 (externalities on the employees of takeover targets); Bebchuk, *supra* note 22 (externalities on consumers, tax authorities, etc.).

43 The study examined merger gains to targets and their industry rivals and found evidence consistent with my argument regarding diversion of takeover activity. It found that rivals benefit from the merger announcement, but the termination results in significant negative returns for targets and significant positive returns for rivals. The fact that rivals enjoy termination gains supports the hypothesis that rival firms

lengthy and expensive, the takeover shields of all relevant targets must be considered. Clearly, if target *A* is equally attractive to the bidder as target *B*, then the target that is less shielded is the one more likely to be pursued. If, however, acquisition of the shielded target can produce much higher gains than can acquiring the unshielded target, the former will be pursued, even if it would have been easier to acquire the latter.⁴⁴

The discussion above falls within the boundaries of the rational or nexus of contracts approach to the corporation. However, it abandons the implied assumption of the prior literature that the benefits of rejecting ATPs do not fluctuate with the number of firms on the market that adopt ATPs. I suggest, instead, that as a result of takeover diversion, the greater the number of firms that adopt ATPs, the higher the benefits that accrue to the firms that reject them. This argument may be formulated as a demand-side explanation. The more firms there are producing unshielded targets (and, therefore, the fewer firms adopting ATPs), the lower the price that the market is willing to pay for the unshielded product. Conversely, the fewer the number of firms producing unshielded targets, the higher the price the market will place on each unshielded target.

The demand-side explanation, taken together with the classic literature on ATPs, may solve the ATP conundrum. Some (or even all) firms possess features that cause them to derive high benefits from the adoption of ATPs, such as an increased takeover premium. However, the greater the number of firms that adopt ATPs, the higher the expected premia their unshielded peers can hope for since they enjoy the diverted takeover activity. The market stabilizes at the point where the marginal firm is indifferent to the adoption of ATPs, since both tactics provide similar benefits. Put differently, there is

could become acquisition targets. The gains are positively related to subsequent acquisition activity involving the target and the extent of merger activity in the industry and inversely related to the relative size of the target rivals, the presence of a competing bidder, and the regulatory environment. See Aigbe Akhigbe et al., *The Source of Gains to Targets and Their Industry Rivals: Evidence Based on Terminated Merger Proposals*, 29 *Fin. Mgmt.* 101 (2000).

- 44 Conducting a comparative analysis of potential targets is a natural step in the business reality of acquisitions. In a candid interview to the business press, William Steere, the CEO of Pfizer, revealed the process that led Pfizer to launch its famous hostile takeover bid to acquire Warner Lambert. The decision to acquire Warner Lambert resulted from a careful analysis of the fitness and costs of other takeover alternatives. The costs of takeover shields are not mentioned explicitly by Pfizer's CEO, but Warner Lambert was cited by the business press as having had minimal takeover protection and, hence, was relatively easy to acquire. Robert Langreth, *Behind Pfizer's Takeover Battle: An Urgent Need*, *Wall St. J.*, Feb. 8, 2000, at B1.

an equilibrium at which corporations diverge in their ATP preferences, even if all corporations share the same attitude regarding ATPs.

IV. THE FIRM AS AN ORGANISM AND EVOLUTIONARY EXPLANATIONS

The discussion so far has shown that three of Rubin's proposed models of the organization may shed light on ATP anomalies, at least when one considers interactions among organizations. Rubin's fourth suggestion, to view the organization as an organism, may also contribute to the inquiry. In particular, there are several weaknesses to the discussion in Part III above (in the framework of the nexus of contracts approach to the firm), which such a view may remedy. Takeover diversion and interaction among firms, which creates the market equilibrium in the backdrop of this diversion, are a story based on traditional game theory. This story assumes that the players (the corporations) are fully rational and have complete knowledge of the details of the game. This assumption is highly questionable, as it seems that the concept of takeover diversion considered in Part III has never been recognized by the market.

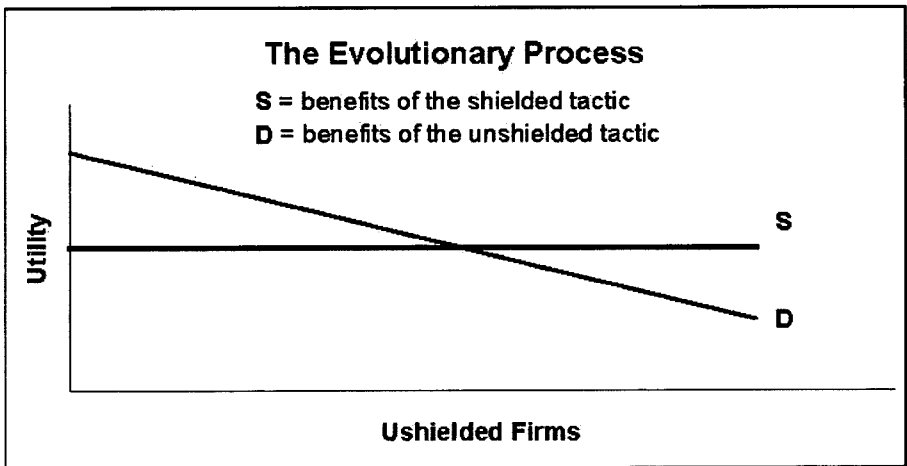
In contrast to traditional game theory models, evolutionary game theory models do not build on the rationality of the players and therefore may be applied to predict the behavior of organisms.⁴⁵ The evolutionary models also outline the process that leads to the equilibrium. An explanation of such a process was absent from the argument in Part III. In the framework of the discussion in this Part, I assume corporations to behave as organisms because they are unaware of the details of the "game" they are playing (the fact that there is takeover diversion from shielded to non-shielded targets).⁴⁶ I also assume, however, that corporations can recognize, at any stage of the game, which of the two strategies (adoption or rejection of ATPs) is more beneficial to them. This knowledge may be the result of underwriters' guidance when the firm

45 Evolutionary game theory is a thriving branch of game theory. For a comprehensive review of the field, see Larry Samuelson, *Evolutionary Games and Equilibrium Selection* (1997).

46 Therefore, my usage of the metaphor of the corporation as an organism deviates from the manner in which Rubin uses it, as I explained before, *see supra* Part I. My usage resembles the way in which evolutionary game theory uses the metaphor to describe the behavior of real organisms. For instance, Axelrod, in his well-known book *The Evolution of Cooperation*, shows how biological systems may reach an equilibrium and also how the organisms in such systems have no ability to understand the properties of the game they are playing. Robert Axelrod, *The Evolution of Cooperation* 88 (1984).

goes public. Underwriters, too, might not understand the details of the ATP game, nor anticipate the long-run equilibrium, but their close acquaintance with the market helps them develop hunches regarding the optimal strategy for the current stage of the game.

The evolutionary process that may emerge is explained with the aid of the graph below. This graph contains all the details of the ATP game that the players do not discern. There is a downward sloping demand curve in the graph, which represents the benefits accruing to a firm that elects to remain unshielded. The benefits for the unshielded firm decline the more unshielded firms there are in the market, since there are less shielded firms that divert takeover activity and more unshielded counterparts with whom to share the diverted takeover activity. For purposes of simplicity, I assume that the other curve, representing the benefits of the shielded strategy, is flat.⁴⁷



Note that unlike the depiction in the graph above, the supply and demand curves theoretically may never intersect. This would mean that ATPs are either entirely harmful or entirely beneficial for all firms with similar ATP preferences. However, if the two curves do intersect, the diversion of takeover activity has eroded the benefits of defenses to the point where only

⁴⁷ Since the costs of producing an unshielded target are the relinquished benefits of being shielded, the curve representing the benefits derived by each firm from adopting defenses may also be termed a supply curve. And since the empirical literature did not find any relevant dissimilarity among shielded and unshielded firms, one can assume that they all bear the same costs of foregoing defenses, which is represented by a flat supply curve.

part of the market should adopt defenses in equilibrium. This equilibrium may be reached through an evolutionary process, as discussed below.

Let us first assume that when a given IPO-stage firm enters the market, all incumbent targets maintain shields (which, in the graph, would be represented by $X=0$). In this case, it is best for the firm going public not to adopt shields (note how on the left side of the graph, the demand curve, representing the benefits of being unshielded, tops the supply curve, which represents the benefits of being shielded). Now, let us assume that another IPO-stage firm enters the market and has to decide whether or not to adopt shields. By this time, however, the ratio of shielded to unshielded has actually changed from what it was when the first firm made its decision, because now there is one unshielded target. Put differently, the second firm does not find itself at the extreme end of the continuum where there are zero unshielded firms in the market.

Nevertheless, as long as the demand curve tops the supply curve, the second firm will also refrain from using a shield, as being shielded will still be the inferior tactic. As the number of unshielded targets grows, the market gradually moves toward the right end of the graph. Firms will follow suit in not adopting shields until the demand curve intersects with the supply curve. At the point of intersection, the issue of ATP adoption or rejection is moot to takeover candidates. Thereafter, ATPs should be neither adopted nor rejected in any sort of systematic fashion. Moreover, if the market shifts back to the left side of the graph, for any reason whatsoever, it will gradually slide back to the point of intersection between the two curves in the process that was previously described.

Similarly, if a firm enters the market at a point in time when there are no shielded firms, which is represented by the furthest point at the right end of the graph, the market will climb to the point of intersection between the two curves. The first firm will reckon that it is better to be shielded when all others are unshielded (which is demonstrated where the supply curve is higher than the demand curve). Other firms will follow suit up until the point at which the two curves intersect. This point of intersection is a stable equilibrium insofar as market forces will correct any deviation therefrom.

This explanation may also shed light on another mystery of ATP practices among IPO-stage firms. Apparently, over the last decade, the rate of ATP-adoption among IPO-stage firms has grown dramatically. Coates argues that this tendency may be the result of a beneficial learning process among lawyers handling IPOs,⁴⁸ but the description above offers a different, less optimistic story.

48 See Coates, *supra* note 2, at 1383.

Underwriters, when they make the valuation of an IPO issuer, must cater to the market in order to preserve their reputations. This mechanism pressures issuers into adopting optimal governance structures. However, if firms are similar in their preferences, as Coates suggests, and the equilibrium is at the point where all firms are indifferent to adoption of ATPs, then the ATP decision will not alter underwriters' valuations of issuers.⁴⁹ The legal advisers of the issuers may interpret this underwriter indifference to the ATP question, which is justified only when the market is close to the equilibrium, as a sign that ATPs are always benign factors in a firm's valuation.⁵⁰ Therefore, these same lawyers may systematically advise their clients to adopt ATPs at the IPO stage, for if adopting ATPs does not harm the valuation of the firm, then the managers of the issuer should always prefer it, as it helps them hold on to their offices.

This legal advice, however, pushes the market away from the equilibrium. The market becomes saturated with shielded firms that divert takeover activity to their unshielded peers, making ATP-rejection a more favorable strategy. At first, the harm to the adopting firms is not salient, since the demand and supply curves are close to one another near the equilibrium. Eventually, however, when the harm of adopting defenses increases, shrewd market professionals will identify the opportunity and push the market back to its point of equilibrium by systematically rejecting defenses.

49 This conclusion is viable only if the benefits of ATPs (which takeover diversion erodes) are based on the bargaining power theory or the myopia theory. If, however, the advantages of ATPs are based on the private benefits of control theory, then although in equilibrium, the pre-IPO owners are indifferent to ATP-adoption, the valuation of firms adopting ATPs would be lower than the valuation of firms rejecting them. The reason for this is that under this theory, the benefits accrued due to ATPs are not reflected in the market value of the firm, since they accrue privately to the managerial team and not to the public shareholders. Note that the private benefits theory can explain the institutional shareholders' disapproval of ATP adoption in seasoned firms. While ATPs are priced at the IPO stage (but some issuers choose to adopt them as explained in this comment), their adoption at a later stage hurts the value of the firm for the public, which does not receive compensation for this harm. For a paper that most clearly presents the question of institutional investor preferences regarding ATPs, see Michael Klausner, Institutional Shareholders' Split Personality on Corporate Governance: Active in Proxies, Passive in IPOs (Nov. 2001) (Stanford Law & Economics Olin Working Paper No. 225), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=292083.

50 In Merton Miller's jargon, it means that ATPs are innocuous or "neutral mutations" in the design of corporate securities. See Merton Miller, *Debt and Taxes*, 32 J. Fin. 261 (1977).

CONCLUSIONS

This comment tested Rubin's suggestion to apply various models of corporate behavior to contend with corporate conduct and to properly design regulation. The test was conducted on the backdrop of a major conundrum and controversy in corporate law, namely, the mystery of firms' divergent behavior in relation to antitakeover defenses at the IPO stage. A major stimulus to applying the different models suggested by Rubin was the apparent fact that the commonly used model of the corporation, the nexus of contracts approach, allegedly does not have enough explanatory power. Indeed, at least two of the models presented by Rubin seem to have the power to shed light on the mystery I have focused on.

Both the model of the firm as a culture and the behavioral approach to the corporation seem to contribute to understanding the subject well beyond any other explanation rooted in the nexus of contracts approach. In conducting this analytical exercise, I deviated from the classic corporate law approach in another manner: instead of looking at every corporation as a stand-alone entity and thus focusing on the interactions between the corporate constituencies of such an entity, I focused on interactions *among* corporations. With the coupling of the advanced models of corporate behavior suggested by Rubin with a focus on the interactions among different corporations, the explanatory powers of these models seemed even more promising.

At that stage in the analysis, however, I revisited the basic nexus of contracts model of corporate behavior and showed that if we focus on interactions among firms, even the basic nexus of contracts approach produces a logical explanation for the ATP mystery. I argued that the greater the number of firms that adopt ATPs, the higher the benefits that accrue to the firms that reject them. The reason for this is that not only do ATPs prevent takeovers, they also divert takeover activity to unshielded targets. The adoption of ATPs by a firm benefits its unshielded peers because purchasers make comparative analyses in their decision-making processes. In addition to looking at the functional characteristics of the different potential targets, bidders compare the degree of ease with which each target may be acquired. Therefore, in order to get a complete picture of a company's takeover prospects, we must consider not only the company's defenses, but also those of its peers.

Put differently, the takeover risk to an individual firm is not endogenous to its antitakeover decisions. Each prospective bidder naturally confronts a limited pool of suitable targets from which to choose. Thus, every potential target must consider the defenses available to other prospective targets. The

defensive decisions of one firm may divert takeover activity to another firm, which, in turn, may affect the average takeover premium that the latter may reasonably expect in a takeover event.⁵¹ Taken together, this explanation and explanations previously raised in the literature may help to solve the conundrum of the diversity in firm behavior at the IPO stage. Some firms may have particular features that cause them to derive greater benefit from adopting ATPs than do other firms. However, as stated, the greater the number of firms that adopt ATPs, the higher the premia their unshielded peers can hope for. The market stabilizes at the point where the marginal firm is indifferent to the adoption of ATPs, since both tactics provide similar benefits.

The fact that the empirical studies could not find evidence pointing to ATP-adopting firms as those possessing the special features that make ATPs particularly valuable should not be taken as a discouraging sign. The relevant differences among issuers may be mild or theoretically non-existent, but nevertheless, only some of the firms would elect to remain unshielded. Put differently, even if all firms are similar in all relevant features, they may diverge in their ATP decisions. The reason for this is that even if ATPs were to provide similar benefits to all firms, an adoption trend would raise the benefits accruing to unshielded firms. Eventually, at some ratio of ATP adoption, the benefits of the two strategies would become equal for all firms and the market would maintain this ratio.

To some extent, this revelation may serve as a warning for those who choose to follow Rubin's suggestion. The consideration of advanced models of corporate behavior should not serve as an excuse to forsake a more careful analysis of the rational framework. Moreover, the advanced models advocated by Rubin have been only briefly discussed, if at all, in the corporate law arena. Hence, it might be dangerous to gauge corporate behavior and decide upon the proper regulatory response based solely on an understanding that rests on such models. While an in-depth review of the advanced models seems important and may become fruitful, one must be careful in their application for the time being.

51 The discussion in this comment relies on the existence of a *corporate stagnation* effect regarding ATPs, a phenomenon that I have analyzed in Hannes, *supra* note 7. As the empirical evidence clearly indicates, seasoned firms that entered the 1990s with ATPs do not tend to repeal them, but the rest of the mature firm population seldom adopts new ATPs. This means that managers are potent enough to maintain ATPs in the former type of firm and stockholders are potent enough to resist adoption of ATPs in the latter. See Coates, *supra* note 2, at 1308; Hannes, *supra* note 7.

