ISSN 1045-6333

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Discussion Paper No. 343
11/2001

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Cambridge, MA 02138

The Center for Law, Economics, and Business is supported by
a grant from the John M. Olin Foundation.

Forthcoming 96 *Northwestern University Law Review* _ (2002)

Last Revision: November 2001
Comments welcome

OPTIMAL DEFAULTS FOR CORPORATE LAW EVOLUTION

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Abstract

Public corporations live in a dynamic and ever-changing business environment. This paper examines how courts and legislators should choose default arrangements in the corporate area to address new circumstances. We show that the interests of the shareholders of existing companies would not be served by adopting those defaults arrangements that public officials view as most likely to be value-enhancing. Because any charter amendment requires the board's initiative, opting out of an inefficient default arrangement is much more likely to occur when management disfavors the arrangement than management supports it. We develop a "reversible defaults" approach that takes into account this asymmetry. When public officials must choose between two or more default arrangements and face significant uncertainty as to which one would best serve shareholders, they should err in favor of the arrangement that is less favorable to managers. Such an approach, we show, would make it most likely that companies would be ultimately governed by the arrangement that would maximize shareholder value. Evaluating some of the main choices that state corporate law has made in the past two decades in light of our proposed approach, we endorse some but question others. The arrangements we examine include those developed with respect to director liability, the regulation of takeover bidders, and the range of permitted defensive tactics.

JEL Keywords: shareholders, managers, directors, default rules, interpretation, takeovers, antitakeover statutes, poison pill, and staggered boards.

JEL: G3, G34, K22

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** John M. Olin Fellow in Law and Economics, Harvard Law School. This paper was prepared for the Van Gorkom symposium, organized by the Center for Corporate Governance at the University of Delaware. The financial support of the Harvard Law School John M. Olin Center for Law, Economics and Business is gratefully acknowledged.

I. CHOOSING DEFAULTS IN A DYNAMIC BUSINESS ENVIRONMENT

This paper focuses on a question that has, in our view, received inadequate attention in the literature on corporate law theory and policy: What approach should guide courts and legislators when they choose a default arrangement to govern a new issue confronting publicly traded companies?[1] This question is important because such companies often live a long life after they go public, and they operate in a dynamic, ever-changing environment. Courts and legislators are therefore often faced with the need to provide default arrangements for contingencies that the corporate charter's original designers either failed to anticipate or to consider thoroughly. In this paper, we provide a theory of optimal corporate-law defaults. We argue that, in choosing default corporate-law arrangements, court and legislators should follow what we call the *reversible default* approach. We also evaluate, in light of our theory, several important choices that state corporate law has made in the last two decades, endorsing some of these choices and suggesting changes in others.

Work on the general considerations that lawmakers should use in designing corporate rules has focused on the criteria for deciding whether a given corporate issue should be governed by a mandatory or by a default rule, that is, on whether companies should be allowed to opt out of the arrangement that the law provides.[2] In contrast, relatively little has been written about the general considerations that should determine the choice of default arrangements in the corporate

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[1] The analysis in this paper focuses on default rules governing publicly-traded companies with dispersed ownership. Thus, unless we indicate otherwise, the term "companies" will refer only to public companies. For an analysis of default rules for close corporations, see Charles R. O'Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis,* 87 NW. U. L. REV. 216 (1992) (discussing specific issues of gap filling with respect to close corporations).

[2] *See generally* Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments,* 102 HARV. L. REV. 1820 (1989); Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

area.[3] This paper focuses on this question and analyzes how such default arrangements should be designed.

The ever-changing nature of the business environment, combined with the long life that many publicly traded companies have, requires corporate law to provide often defaults to govern new circumstances that have received little or no prior attention from the designers of corporate charters. For example, the development of the market for hostile takeovers in the 1970s and the 1980s required public officials to provide default rules to govern the new problems and issues associated with this new business environment. The choice of default arrangements is thus an important question for corporate law policy.

Our analysis takes into account an important difference between two types of companies to which a default rule will apply: companies that will go public in the future ("future IPOs"), after the default's rule adoption, and companies that are already publicly traded at the time the new default is adopted ("existing companies").[4] As we shall show, this distinction is quite significant for the optimal design of default rules. The potential effect of a new default rule on

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[3] One exception is an earlier work by one of us on which we build here. *See* Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1410-13 (1989) (discussing how to examine corporate law defaults in light of managers' control over charter amendments). Other earlier works which examine the question of corporate defaults from a different perspective than ours are Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel,* 59 U. CHI. L. REV. 1391, 1397-400 (1992) (discussing how to design corporate law defaults in light of information-forcing considerations), and Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 826-834 (1995) (examining how to design corporate defaults in light of network externalities). *See also* Sharon Hannes, *The Determinants and Consequences of Corporate Stagnation: Discussion and Reform Proposal*, (working paper, Harvard Law School, 2001, on file with authors) (suggesting that in certain circumstances, to prevent corporate stagnation, all earlier opt-out charter provisions by companies be cancelled).

[4] The importance of this distinction was first highlighted and analyzed in Bebchuk, *supra* note 2, at 1825-29. The differences between the IPO stage and the mid-stream stage were subsequently much discussed and debated in the Columbia Law Review symposium on contractual freedom in corporate law. *See* Bebchuk, *supra* note 3, at 1399-1404 (discussing the problem of contractual freedom with respect to midstream companies); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1442-44 (1989) (same); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1573-85 (1989) (same).

existing companies is especially important, because existing companies wishing to opt out of new default arrangements face some impediments that would not arise in the case of future IPOs. Whenever a default arrangement that legislators or courts adopt turns out to be inefficient, companies going public subsequent to the default arrangement's adoption will most likely opt out of it. Such opting out of defaults that turn out to be inefficient, however, might not take place in existing companies if opting out would be disfavored by management.

When default rules are adopted, they generally affect many companies already in existence. At the time they went public, these companies did not anticipate the developments triggering the adoption of these rules, and they thus did not provide contractual arrangements in their charters to govern these developments. Companies that went public in the 1970s, for example, did not anticipate the mid-1980s invention of the poison pill, the changes in director liability following the *Van Gorkom* decision, or the ways in which classified boards would interact with poison pills to impede hostile takeovers.[5] When these developments emerged in the 1980s and 1990s, courts and legislators had to choose default arrangements, recognizing that these arrangements would affect the large stock of public companies already in existence.

Suppose that courts or legislators have to choose between two possible default arrangements to govern an issue that has recently emerged. A natural and widely accepted approach is to try to assess which of the two arrangements would be more likely to serve shareholder value.[6] Under this approach, when public officials are uncertain which of two

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[5] *See infra* Part III.A (reviewing the reform in the director liability in the aftermath of the *Van Gorkom* decision) and Part III.D (analyzing the interaction of classified boards with the poison pill).

[6] As we explain below, throughout the paper we make a fairly conventional assumption that the desirable corporate arrangement is the one that maximizes shareholder value. Although other views exist about the desirable goal for corporate law, the goal of enhancing shareholder value view is sufficiently important and widely held for it to be worthwhile exploring how default arrangements should be best designed to serve this objective.

possible arrangements would be value-maximizing, they should resolve which arrangement would be more likely, in their judgment, to be the one that, *if applied*, would maximize shareholder value. This question is equivalent to asking which arrangement fully informed and rational shareholders would have most likely chosen had they considered this question.[7] This so-called "hypothetical bargains" approach seeks to identify what arrangement *would have been* most likely adopted by shareholders had they considered the matter when the company first went public.[8]

We argue that, although it seems appealing at first glance, this approach should not be followed because it overlooks a fundamental asymmetry in the process of opting-out of default rules by existing public corporations. Under the prevailing rules of corporate law, shareholders cannot amend the corporate charter without the cooperation of the board of directors.[9] To be

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[7] *See, e.g.*, Klausner, *supra* note 3, at 768 (describing the common view under which content of default terms "should be governed by a judgment regarding the terms that firms would select in the absence of transaction costs"); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 15 (1991) (stating that "[t]he normative thesis of the book is that corporate law should contain the terms people would have negotiated, were the costs of negotiating at arm's length for every contingency sufficiently low"); Gordon, *supra* note 4, at 1593-97 (1989) (applying the standard to set the standard of fiduciary duties for directors).

[8] The hypothetical bargains approach is the predominant theory of contractual interpretation. *See generally* David Charny*, Hypothetical Bargains: The Normative Structure of Contract Interpretation,* 89 MICH. L. REV. 1815 (1991). Recently, it has been endorsed also in the context of statutory interpretation. *See* Einar Elhauge*,* Preference Estimating Statutory Defaults (Working Paper, 2001); Adrian Vermeule, *Interpretive Choice,* 75 N.Y.U. L. REV. 74, 85 (2000) (describing some canons of statutory interpretation as "majoritarian default rules – attempts to capture what Congress would have said had it spoken to the question").

Some work on default rules in contract has focused on how default rules might be best designed to induce an efficient transfer of information from some parties to others. *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); Lucian Arye Bebchuk & Steven Shavell, *Reconsidering Contractual Liability and the Incentive to Reveal Information,* 51 STAN. L. REV. 1615 (1999); Lucian Arye Bebchuk & Steven Shavell, *Information and the Scope of Liability for Breach of Contract: The Rule of* Hadley v. Baxendale, 7 J.L. ECON. & ORG. 284 (1991) [hereinafter Bebchuk & Shavell, *Information and Liability*]. *See also* Ayres, *supra* note 3, at 1397-400 (applying this "information-forcing" approach to the design of default rules for corporate law). In our view, such considerations are not very important for the choice of default rules for existing companies.

[9] *See infra* text accompanying footnotes 26-25.

sure, a charter amendment requires a vote of shareholder approval. Such votes, however, take place only on amendments initiated by management. Management thus has an effective veto power over charter amendments. As a result, for any level of shareholder support, corporations are much more likely to adopt amendments management favors than amendments management disfavors.

This asymmetry produces a difference in the prospects of reversal by corporations between those default rules that management favors—because they restrict managers less than their alternative—and those alternative, more restrictive rules. Restrictive default rules that are adopted by public officials, but that turn out to be inefficient and thus disfavored by shareholders, will be more likely to be reversed than non-restrictive default rules that turn out to be inefficient. Put differently, undesirable non-restrictive default rules are more likely to persist if initially adopted than undesirable restrictive default rules.

An optimal approach to designing default rules must take this asymmetry into account. If public officials facing a choice between two or more defaults seek to maximize the chances that the value-maximizing arrangement would ultimately govern, the best way is not necessarily to choose the arrangement that they estimate to be the one most likely to be value-maximizing. Rather, when public officials face significant uncertainty about which choice would be value-maximizing, a better strategy often would be to make their choice in a way designed to facilitate change in the event that the chosen default arrangement does not turn out to be the one shareholders favor.

Our *reversible default* approach for choosing default rules of corporate law can be summarized as follows: Whenever public officials face a choice between two default arrangements, one more restrictive and one less restrictive with respect to management, erring on the side of the more restrictive arrangement would carry with it a certain important advantage. If the restrictive arrangement is chosen, and then turns out to be inefficient, relatively little will be lost because both shareholders and managers will support a charter amendment opting out of this inefficient arrangement. In contrast, when opting out requires a charter amendment, if the non-restrictive arrangement is chosen and then turns out to be inefficient, it might often persist despite its inefficiency. Alternatively, public officials can adopt the more restrictive arrangement as a default, but only if shareholders can unilaterally opt out via a bylaws amendment.

The theory we develop in this paper has important implications for the many instances in which courts and legislatures must adopt default rules to govern situations that were largely unanticipated at the time most of the affected companies went public. We apply our reversible default approach to evaluate several important cases from the last two decades in which public officials have adopted default rules.

We first examine the approach followed by state legislators in the aftermath of the *Van Gorkom* case.[10] This case, which was regarded as a sign of heightened scrutiny of director actions, and the D & O insurance crisis, led Delaware and other states to expand the menu of choices available to public companies to include the option of limited monetary liability for directors. This change in the rules governing director liability could have been effected in two ways: by adopting the new "lenient" arrangement as a default, and allowing companies to opt out of it; or by keeping the old "stringent" arrangement as the default, and allowing companies to opt out of it to the new lenient arrangement. Delaware and most other states chose the second path and applied the new arrangement only to companies that explicitly adopted it in their charter. As our analysis shows, the path taken by Delaware and those other states was the desirable one.

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[10] Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

Had the lenient arrangement been set as default, shareholders might well have been unable to amend the charter to opt out of it even if it turned out that they disfavored it.

We next examine the ”bidder-restriction” antitakeover statutes that limit the behavior of a successful bidder after a hostile takeover. Most states adopting these statutes did not wish to impose a mandatory arrangement on companies. These states, however, adopted the regime that restricts bidders as a default arrangement, requiring opting out for companies to be governed by a regime that is less restrictive of takeovers. From the perspective of the reversible defaults approach, this choice of the antitakeover regime as the default is highly problematic. Rules restricting hostile takeovers clearly favor management—they impede a hostile bidder’s ability to take over and replace the board. Thus, management might not initiate charter amendments opting out of bidder-restriction defaults even if these defaults turn out to be disfavored by shareholders. Accordingly, the desirable route was either to require opting *into* the antitakeover regime by charter amendment or to allow shareholders to opt out of the protective regime by amending the bylaws.

We next examine the default rules governing the adoption of poison pills. Invented in the 1980s, the poison pill was a new tool whose use could fundamentally alter the balance of power between shareholder and management.[11] After some evolution through judicial decisions and the adoption by some states of poison pill endorsement statutes, state law moved toward allowing the board to use pills. When choosing between allowing and disallowing boards’ antitakeover use of pills, state corporate law has chosen the regime allowing such use as a default, thus requiring a charter provision prohibiting pills to prevent managers from using them. Again, we

[11] To be sure, the introduction of poison pills took advantage of the formal power that managers always had—the power to issue securities. Yet, such use of this managerial power had not been anticipated earlier. *See* our discussion in Part III.C. *infra*.

view this choice of default as undesirable. Allowing managers to adopt the pill was clearly the arrangement managers favored. Thus, the desirable route was either to require a charter amendment for having a regime permitting poison pills or to provide such a regime as a default but then to allow opting out of it via bylaws amendment.

Finally, we examine the rules governing the powerful antitakeover defenses created by combining poison pills with antitakeover charter provisions (ATPs), especially provisions establishing a classified board. A poison pill by itself can hardly impede a hostile bidder whose offer is attractive to shareholders. The pill can become a serious impediment, however, when combined with ATPs that otherwise impede winning a proxy contest for control of the board.

Although including a provision establishing a classified board in a charter could not have occurred without shareholders' explicit or implicit consent, whether the *antitakeover use* of such a provision can be viewed as grounded in shareholder consent critically depends on when the company adopted the provision. Shareholders of companies that adopted classified boards prior to the late 1980's could not have reasonably anticipated the developments in poison pill doctrine that made a combination of classified board with a poison pill an extremely powerful antitakeover device. Thus, shareholders of these companies found themselves in the 1990s governed by an arrangement whose far-reaching antitakeover consequences they could not have anticipated the company adopted its ATPs.

Under the reversible defaults approach, it would be desirable to have this powerful antitakeover device in place only when shareholders have genuinely opted into having it. Although state law on this subject has thus far not evolved in this way, we put forward two ways in which the reversible defaults approach could be implemented going forward. The first alternative would prevent managers from taking advantage of classified boards that were adopted prior to 1990 and not ratified subsequently from using such board classification to create strong antitakeover defenses. Managers of such companies should not be allowed to maintain a pill to block a bid after losing an election in which the bid was the main issue. An alternative approach would be to allow shareholders of such companies to initiate and adopt bylaw amendments limiting the ability of the board to adopt a poison pill or to maintain it following a defeat in such an election.

The remainder of this paper is organized as follows. Part II highlights the importance of default rules for corporate law, and makes the case for adopting the reversible default approach. Part III applies the reversible default approach to evaluate several major developments of corporate law in the past two decades. Finally, Part IV concludes.

II. A THEORY OF OPTIMAL CORPORATE DEFAULTS

This Part presents the case for the reversible defaults approach in choosing corporate-law defaults. Section A discusses the need for corporate law defaults. Section B outlines the choice of default arrangements for companies going public in the future. Section C considers the choice of default rules for existing public companies.

A. Defaults in a Changing World

1. The Evolution of Corporate Law

This paper focuses on the legal regulation of publicly traded companies, especially ones with dispersed ownership. Such companies pose different problems than those of close corporations.[12] As we shall see, the agency problem underlying the public corporation affects the ability of the public corporation to opt out of inefficient default arrangements.[13]

We should also note that our focus is on those issues that corporate law has chosen to subject to contractual freedom. Some aspects of corporate governance are regulated in a mandatory fashion,[14] and there has been an extensive debate as to the scope of issues that should be governed by mandatory rules.[15] There is no dispute, however, that a substantial part (if not all) of corporate governance should be regulated in an enabling manner, allowing companies to choose the arrangement that will govern them.

Even for arrangements that companies are free to shape, however, corporate law plays the important role of providing defaults. Corporate charters, the main vehicle through which companies specify the arrangements that will govern them, are inevitably incomplete, requiring corporate law to "fill the gaps." There are two reasons for gaps in corporate charters. First, transaction costs make it costly to specify an arrangement for each and every issue, even for ones that can be anticipated to arise when the charter is adopted. Second, and for our purposes more importantly, initial charters will inevitably fail to address novel contingencies that drafters did

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[12] For an analysis of additional implications of the distinction between close and publicly held corporations, see Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986).

[13] On the agency problem associated with the inherent conflict interest between managers and shareholders of public companies, see Michael Jensen and William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305 (1976); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J. LAW & ECON. 327 (1983).

[14] Two prominent examples are insider trading and the duty of loyalty of corporate directors. *See* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983) (analyzing the mandatory nature of the prohibition on insider trading); Melvin A. Eisenberg, *Corporate Law and Social Norms,* 99 COLUM. L. REV. 1253, 1271-78 (1999) (justifying the mandatory nature of the duty of loyalty).

[15] *See generally* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (J. Pratt & R. Zeckhouser eds., 1985); John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies,* 53 BROOK. L. REV. 919 (1988); Symposium, *supra* note 2.

not anticipate at the time of their adoption. Corporate law is thus required to provide default arrangements to address these new contingencies until the time (if ever) that corporations adopt charter provisions with respect to them.[16]

Gaps of the second type are of great significance for the corporate law governing publicly traded companies. Such companies are often long-living entities operating in a dynamic and ever-changing business environment. As a consequence, it is likely that contingencies will emerge that received little or no attention when companies' initial charters were adopted. Companies that went public in the 1970s or earlier, for example, did not anticipate the invention of the poison pill in the 1980s or, more generally, the current dynamics of the takeover market. Similarly, such companies also had no reason to anticipate the adoption in the 1980s of an enabling approach, and the resulting expanded menu of choices, with respect to director liability for duty of care violations. With respect to companies that went public before the 1970s, corporate law in the 1980s and 1990s had to provide defaults for these issues that were clearly unanticipated when the companies went public.

Although we use the language of providing new defaults for novel contingencies, our analysis applies also to situations in which a default that is formally in place was clearly not chosen with the anticipation of these new contingencies, making it desirable to provide a default for these new circumstances. For example, the Delaware statute has long had a provision providing managers with the formal power to design the terms of issued securities, thus providing them with the flexibility needed to raise capital effectively.[17] Until the poison pill invention, however, it was not anticipated managers could use this formal power not only in

[16] On the role of default rules in contracts see generally Charny, *supra* note 8.

[17] *See* DEL. CODE ANN. tit. 8, § 157 (1991) (granting the board the power to issue securities and set terms that would apply to these securities).

connection with raising capital but also with the unrelated goal of blocking a hostile bid. The developments in the takeover market, and the accompanying invention of the poison pill, thus confronted companies and public officials with a new issue: As long as the corporate charter is silent on the issue, should managers be able to use the formal power to issue securities with various terms to block a hostile bidder?[18]

2. Defaults and Imperfect Information

In developing a theory of corporate law defaults, we must proceed using the premise that market players and investors in any given company are more likely than public officials to identify the superior arrangement for their company. This assumption is the natural one to make considering issues with respect to which corporate law has already made the choice to favor a default arrangement over a mandatory arrangement. Indeed, the informational superiority of market participants is the very reason for allowing companies to opt out of certain default arrangements provided by public officials. Issues for which pubic officials are likely to know better than market participants what the desirable arrangement is should be regulated by a mandatory rule and thus should be outside the scope of the theory of corporate law defaults. Below we will therefore assume that shareholders know better than public officials what arrangement would serve them.

Not knowing as well as investors which arrangement would be best with respect to the considered issues, public officials will have to operate under conditions of imperfect

[18] *See* discussion *infra* Part III.C. Thus, in our view, the choice of defaults is a time- and situation-specific exercise. Given whatever the charter, or the provisions of the relevant corporate statute, say, public officials might stipulate a different default arrangement at time i than at time j.

information.[19] Their uncertainty over the identity of the desirable arrangement with respect to any given issue can stem from two distinct sources. First, even assuming all public companies are homogeneous,[20] public officials might be uncertain about the overall effect of a given default arrangement on shareholder value. Second, when public companies differ in the identity of the arrangement that would be optimal for them, public officials might be unable to distinguish between companies of different type and to match each company with the arrangement best fitting it.

Accordingly, our analysis below applies to two conceptually distinct cases. Suppose that public officials must choose between two default arrangements, A and B, to govern a new contingency. One "pure" scenario to consider involves only the first type of uncertainty. In this scenario, companies are homogeneous and the arrangement that would be best for some would be best for all but public officials cannot identify this best arrangement with certainty. Rather, they estimate by $1-P$ the likelihood that A is the more efficient arrangement, and by P the likelihood that B is the more efficient arrangement.

A second "pure" scenario to consider is one in which only the second type of uncertainty exists. Suppose that companies are heterogeneous and that public officials know that A is the efficient arrangement for companies of type I, and that B is the efficient arrangement for companies of type II. They also know that companies of type I constitute a fraction α of all companies, and that companies of type II accordingly constitute a fraction $1-\alpha$ of companies.

[19] *See also* Vermeule, *supra* note 8, at 100 (describing statutory interpretation as "an exercise in decisionmaking under conditions of severe empirical uncertainty").

[20] Note that by homogeneous all we mean is homogeneous with respect to the likely effect of the particular default arrangement on the value of the company's shares. Companies can be heterogeneous with respect to other dimensions.

Public officials, however, lack information about any given company's type and thus cannot apply to each group of companies the arrangement, A or B, that best fits it.

For simplicity of presentation, our analysis below will mostly refer to the first scenario in which companies are homogeneous and public officials lack information about which arrangement would overall work best. It should be clear, however, that our analysis equally applies to the second "pure" scenario or to cases in which public officials have the two types of uncertainty.

It will be useful to consider a concrete example. Suppose that public officials have to choose between A and B and believe that the efficient arrangement would increase total shareholder value by 100 compared with the less efficient arrangement. They are not sure, however, which arrangement is better. Rather, they estimate that there is a likelihood of 55% that A is the better arrangement and a likelihood of only 45% that B is the better one. What strategy can the public officials employ to make it most likely that companies will be governed by the best arrangement?

Under the conventional hypothetical-bargains approach, public officials should adopt arrangement A in this example. Assuming that the arrangement the officials choose is going to remain and will govern, choosing A will produce a probability of 55% of getting it right, whereas choosing B will produce a probability of 45% of such an outcome. As we shall explain below, however, this approach would not necessarily be the correct one once we take into account the possibility that the choice companies will reverse the choice public officials made.

B. Optimal Defaults for Future IPOs

The mechanisms for opting out of default arrangements by future IPOs differ from the mechanisms for opting out by existing companies. As a result, the optimal default arrangement might not be identical for both types of companies. It will be useful to start by examining the choice of defaults for future IPOs.

At the IPO stage, the provisions of the charter are chosen by the party, or parties, (the "founder") that takes the company public. While these charter provisions are not the product of actual bargaining between the founder and public investors, the interests of public investors are taken into account through the effect of charter provisions on share prices. Assuming investors are aware of the effect that charter provisions will have on shareholder value, the price that they will be willing to pay for the company's shares will reflect the effect of charter provisions on share value. Thus, for charter provisions priced accurately by the market, the founder will internalize the interests of public shareholders and adopt the most efficient charter provisions.[21]

Accordingly, assuming that a chosen default will apply only to future IPOs, the optimal approach for choosing it is relatively straightforward. If opting into any of the considered candidates for the default arrangement is equally easy, it will be desirable to apply the hypothetical bargains approach and choose the arrangement most likely to be efficient. In our example, public officials should choose arrangement A because it is the arrangement that has the higher likelihood —fifty-five percent—of maximizing shareholder value.

Following the hypothetical bargains approach here, so the argument goes, would increase the likelihood of getting to the desirable arrangement without opting out and thus minimize the

[21] *See* Easterbrook and Fischel, *supra* note 4, at 1421 (taking the view that entrepreneurs will adopt charter provisions that are most likely to maximize expected value); Jensen & Meckling, *supra* note 12 (same).

expected transaction costs that might be incurred. In the case of homogenous companies and uncertainty about whether A or B would be generally best, choosing A would produce a likelihood of 55% that no company will need to opt out and thus no companies will incur transaction costs. In the case in which companies are assumed to be heterogeneous, choosing A again would be optimal; such a choice would require only 45% of the companies to opt out (and incur transaction costs) to get their desired arrangement. In contrast, choosing B would require 55% of the companies to opt out (and incur transaction costs) to get their desired arrangement.

Before concluding the discussion of future IPOs, however, it should be stressed that this set of companies is the one with respect to which the choice of default is relatively unimportant. Although choosing A over B for these companies would be the right thing to do if a separate default were to be set for future IPOs, the practical significance of the choice between A and B would be relatively small. As explained above, founders taking their companies public have strong incentives to have the best arrangements governing the company and thus to do whatever opting out would be necessary for having these arrangements. Thus, the adverse consequences of undesirable defaults would largely not involve the best arrangement not governing companies but rather having somewhat large transaction costs incurred in the designing of initial charters. In contrast, in the case of existing companies to which we now turn, undesirable arrangements that are chosen as default might sometimes "stick."

C. Optimal Defaults for Existing Companies

At any given point of time in which a default is chosen, a large stock of existing companies will be in existence and will be affected by the choice. As we shall show, the considerations involved in choosing defaults for existing companies differ from those relevant for the choice of defaults with respect to future IPOs. In theory, public officials might sometimes consider choosing different defaults for existing companies and for companies that will go public in the future. Practical reasons, however, might call for the use of a single default. Assuming this is the case, we wish to start by pointing out that the considerations relevant for the case of existing companies should play a central role in this choice.

1. The Central Role of Existing Companies for Default Design

In our view, choosing the right default for existing companies is substantially more important that getting the right default for future IPOs. To start with, the stock of existing publicly traded companies at any given point in time is quite large. Thus, when a new rule is adopted, it will take many years for the assets governed by companies that go public after the rule's adoption to exceed the assets governed by companies that went public prior to the rule's adoption. Consider, for example, the arrangement, that the Delaware courts endorsed in 1989, that turns the combination of classified boards and poison pills into a powerful antitakeover device.[22] Even today, more than ten years after the effective adoption of this arrangement, a substantial majority of companies governed by classified boards went public before the arrangement first crystallized.[23]

Furthermore, the expected cost from choosing an undesirable default is likely to be lower for future IPOs than for existing companies. For future IPOs, the damage from choosing incorrectly is always bounded by the transaction costs of opting out in their initial charters. As these transaction costs are relatively low, a chosen default arrangement that would be

[22] For a discussion of the developments in Delaware that led to the emergence of this powerful antitakeover device, see *infra* Part III.D.

[23] *Id.*

substantially inferior to alternative arrangements would never actually govern future IPOs. If the chosen default arrangement is indeed so inferior, its costs would far exceed the transaction costs of opting out, and we can expect future IPOs to opt out of this default.

To state matters in a more formal way, let the cost of opting out in the initial charter by a company going public in the future be C_F, and let the inefficiency costs the inferior arrangement produces be ΔV. The costs produced by choosing the inferior arrangement as a default will never exceed the smaller of C_F and ΔV. In fact, because C_F can be hardly expected to be large relative to the amounts at stake, in the case of future IPOs, inferior default arrangements would largely be replaced.

In contrast, in the case of existing companies, the expected costs from choosing an undesirable arrangement as a default might sometimes be quite large and are not at all generally bounded by the transaction costs involved in opting out. In the case of existing companies, an undesirable default might not be reversed when managers favor it even if its adverse effects on shareholder value are substantial.

2. *The Criterion for Choosing the Criterion*

Given that the choice of defaults for existing companies is important, let us start examining this choice by considering a meta-question—what criterion should be used to determine the desirable approach for public officials to follow in choosing default arrangements for such companies?[24] The desirable criterion, we argue, calls for the adoption of an approach that would minimize the expected costs of deviations from the optimal corporate arrangements.

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[24] For a discussion of this question, *see* Bebchuk, *supra* note 2 at, at 1831-35.

Such a meta-criterion is the one that rational and fully informed parties to the corporate contract would have chosen *ex ante* had they considered the criterion that should guide public officials in setting defaults. When companies are formed, the corporate contract—which consists of the terms supplied by corporate law and the terms supplied by the parties in the charter and in the bylaws—can be viewed as also including the mechanism that would determine how the substantive arrangements governing the company might change over time. Such changes can arise from changes in the charter and bylaw provisions and from the adoption of new legal defaults and any additional terms provided by future choices of defaults.

Ex ante, rational and informed parties would want public officials to fill gaps in a way that would minimize the expected costs of deviations from the value-maximizing arrangement. In the case of existing companies, however, such approach would not be implemented by officials choosing the arrangement that they view as most likely to be value-maximizing. It would instead, as explained below, be implemented by following the *reversible default* approach.

3. *Charter Amendments and the Mid-Stream Problem*

The case for the reversible defaults approach is rooted in the presence of asymmetry between the reversibility of defaults that management favors and disfavors. Our analysis takes as given the prevailing principles of corporate law concerning the power of managers in corporate decision-making in general and in charter amendments in particular.[25] We appreciate that these principles are not an inevitable feature of corporate law, and one of us questions them in a

[25] *See* DEL. CODE ANN. tit 8, § 251 (1991); Rev. Model Bus. Corp. Act § 10.03(a)-(c) (1985).

separate work.[26] These principles are long standing and widely accepted, however, and an inquiry taking them as given might thus be worthwhile.

On most important issues, corporate law requires companies wishing to opt out of a default arrangement to do so by amending their charters. Charter amendments, in turn, require shareholder approval by a majority of the outstanding stocks. Shareholders can only act, however, on the basis of proposals put forward by the board of directors.[27] Shareholders cannot ever initiate charter amendment. The board thus enjoys a veto power over such amendments.

This veto power of the board produces an asymmetry between arrangements favored by management and arrangements disfavored by management. Value-decreasing default arrangements that management disfavors would be presumably reversed. Shareholders would support a move to a value-increasing arrangement and managers would be more than happy in this case to initiate a charter amendment.

In contrast, value-decreasing default arrangements that management favors might well persist. Managers might well not initiate a charter amendment to move away from a default that favors them. To be sure, we do not claim that a charter amendment that management disfavors would never pass. When the matter is sufficiently important to shareholders, and if shareholders can exert sufficient pressure on management, such pressure can lead management to agree to propose a charter amendment that does no directly favor managers.[28] For example, when Pennsylvania enacted an antitakeover statute that was widely perceived as extreme and excessive, pressure from institutional investors led the majority of Pennsylvania companies'

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[26] *See* Lucian A. Bebchuk, The Allocation of Power between Managers and Shareholders*,* (Working Paper, 2001).

[27] *See supra* note 25.

[28] *See, e.g.*, David Skeel, Jr., *Shaming in Corporate Law,* 149 U. PA. L. REV. 1811 (2001) (describing how external pressure on the board might lead it to take shareholder interests into account).

boards to opt out of this arrangement.[29] For our purposes, what is critical is only that there are impediments to reversing a default arrangement favored by managers and that such an arrangement thus might well not be reversed even if the arrangement is value-decreasing and the transaction costs of changing it are small. The problem is that default arrangements favoring managers are likely to "stick."

4. *Optimal Defaults When Opting Out Requires a Charter Amendment*

The asymmetry between the reversibility of defaults that are and are not favored by managers leads to the reversible default approach. Under this approach, whenever there is uncertainty over the identity of the value-maximizing arrangement, a preference should generally be given to the alternative that is more restrictive of managers. This restrictive alternative would be reversed if it turns out to be value-decreasing, whereas the alternative favored by managers would remain in place if chosen as default even if it turned out to be value-decreasing.[30]

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[29] *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 68 (1993); Samuel H. Szewczyk & George P. Tsetsekos, *State Intervention in the Market for Corporate Control: The Case of Pennsylvania Senate Bill 1310,* 31 J. FIN. ECON. 3,18 (1992).

[30] It is worth noting how our argument concerning the tendency of certain default arrangements to persist despite their inefficiency is different from similar arguments made in the behavioral literature. The behavioral literature suggests that the choice of default rules matters due to the "status quo" bias. *See* Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1111-13 (2000) (arguing that theories of contractual defaults should be revisited in light of the tendency of parties not to contract around default provisions); Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1998) (reporting experimental evidence indicating that parties might decline to contract around default provisions due to the "status quo" bias); Russell Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583 (1998) (same). Our thesis, in contrast, is that how sticky the status quo will be will depend on the nature of the default arrangement and, in particular, on whether management favors or disfavors it.

The reversible default approach can be stated in formal terms as follows. As before, let us denote the two possible defaults by A and B, with A being the arrangement less restrictive of managers. Similarly, let ΔV denote the reduction in shareholder value that the inferior arrangement would produce if it were to govern, and let C_E denote the transaction cost of opting out. In this case, if A were to be chosen as a default, and if A turned out to be the value-decreasing arrangement (which has a probability P of occurring), the arrangement A would stick and produce a loss of ΔV. Thus, the expected cost of choosing A is $P * \Delta V$. In contrast, if B were to be chosen as a default, and if B turned out to be the value-decreasing arrangement (which has a likelihood 1-P of occurring), the managers would initiate an opt-out amendment (assuming that ΔV exceeds C_E) and the transaction costs of C_E would be incurred. Thus, the expected cost of choosing B as a default would be $(1-P) * (1 - P) \times C_E < P \times \Delta V$. Thus, under the reversible default approach, B, the arrangement more restrictive of managers, should be chosen as long as

$$(1 - P) \times C_E < P \times \Delta V,$$

or, equivalently, as long as

$$P \geq C_E / (C_E + \Delta V).$$

Because C_E is likely to be much smaller than ΔV, the value of the right hand side of this condition – which is the threshold likelihood of B being the value-decreasing arrangement that would be sufficient to call for B to be chosen under the reversible defaults approach -- can fall substantially below ½. The cost of choosing B when the value-increasing arrangement is A is limited to the transaction costs C_E involved in opting out to A. In contrast, the cost of choosing

A when the value-increasing arrangement is B is the cost ΔV of being "stuck" with the value-decreasing arrangement. For this reason, the expected costs of choosing B can be smaller than those of choosing A even if P is smaller than ½.

Note that the larger the cost ΔV of having the value-decreasing arrangement govern the company, the smaller the level of doubt needed to make it desirable to err in favor of choosing the arrangement that is more restrictive of management even if it does not appear to be the one most likely to be value-maximizing. Thus, the presumption in favor of the arrangement more restrictive of managers is especially strong for corporate issues that are important and likely to have a significant effect on shareholder value. For example, the regulation of corporate directors and the fiduciary duties of managers, two issues that Part III will discuss in detail, are likely to affect shareholder value significantly and thus warrant a strong presumption against the choice less restrictive of managers.

Of course, the reversible defaults approach does not always call for choosing B. Having a presumption against A, the arrangement less restrictive of managers, does not imply that A could not be chosen. The presumption is not absolute. If P is sufficiently small, which would be the case when public officials are sufficiently confident that A would be the value-maximizing arrangement, then it will be desirable to choose A. A very small P implies that little weight should be given to the concern of being stuck with a value-decreasing arrangement.

It will be useful to illustrate the argument with the numerical example used earlier where public officials attach a likelihood of 55% to A being the value-increasing arrangement and a likelihood of 45% to B being the value-increasing arrangement. Suppose that the cost of having the value-decreasing arrangement govern the company is 100 and that the transaction costs of opting out are 10. As we have seen in Section II.B, the conventional hypothetical bargaining approach in this case calls for adopting A. But the reversible defaults approach comes out differently.

If arrangement A is adopted and turns out to be inferior (which has a likelihood of only 45% of occurring), it will not be replaced with arrangement B and the resulting cost will be 100. Thus, the expected cost of choosing arrangement A will be 0.45 x 100 = 45. In contrast, if arrangement B is adopted and turns out to be inferior, the cost that will result will be only 10. Thus, the expected cost of choosing arrangement B is 0.55 x 10 = 5.5, and it would be desirable to adopt arrangement B as a default. In fact, in this example, using the condition derived earlier, arrangement B should be chosen as long as the probability attached to the possibility that it would be value-maximizing is at least 10/(10+100) = 9%.

5. *Optimal Defaults When Opting Out Requires a Bylaws Amendment*

Our discussion thus far has focused on the choice of default arrangements under the assumption that opting out of the chosen default requires a charter amendment. Although important default arrangements usually require charter amendments for opting out, some default arrangements may be reversed by amendments to the corporate bylaws.[31] Unlike charter amendments, bylaw amendments can be initiated by shareholders and do not require board approval.[32]

When opting out can be done by amending the bylaws, the asymmetry that we analyzed between arrangements that favored and disfavored by managers does not arise. This suggests

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[31] *See infra* Part III.B. Our discussion in this section assumes that no limits (such as those established by supermajority requirements) are imposed on shareholder ability to amend the bylaws to opt out of default arrangements. On the implications of imposing such requirements on opting out by amending the bylaws, see our discussion *infra* Part III.B.

[32] *See* DEL. CODE ANN. tit 8, § 109(a) (1991) (granting the power to adopt, amend or repeal bylaws to shareholders); Rev. Model Bus. Corp. Act § 10.20(b) (1985) (same).

that the choice of defaults reversible only by charter amendments should be approached differently from the choice of defaults reversible also by bylaw amendments.

Assuming that opting out in either direction can be done by amendments to the corporate bylaws, there is no asymmetry between arrangements that managers favor and do not favor in terms of the costs arising from choosing a default that turns out to be value-decreasing. In our example, whether A or B is chosen, the power of shareholders to opt out will ensure that the costs of a choice that turns out to be value-decreasing would not exceed the transaction costs of opting out C_E. Accordingly, in such a case, B should be chosen if and only if P is estimated to exceed ½ -- the same condition as is used under the hypothetical contracting approach.

Thus, under the reversible defaults approach, public officials can also decline to use the presumption in favor of the arrangement more restrictive of managers, and choose, instead, whichever arrangement they deem most likely to be value-enhancing, provided that they allow opting out by amending the bylaws. This way public officials would also ensure that, if the chosen default turned out to be value decreasing, shareholders would be able to reverse it easily and not be stuck with a value-decreasing arrangement.

III. APPLICATIONS AND IMPLICATIONS

We have argued that courts and legislators should base default rules for corporate law on the reversible defaults approach. We now turn to evaluate, in light of our proposed approach, several important default arrangements that courts and legislators have chosen in the last two decades. Section A examines the introduction of charter provisions limiting the liability of directors. Section B evaluates state antitakeover legislation. Section C considers the introduction of poison pills, and Section D explores the interaction of ATPs and poison pills.

A. Default Rules for Director Liability

For many years, the fiduciary duties imposed on corporate directors have been a mandatory component of state corporate law.[33] In the mid-1980s, however, many states decided to adopt an enabling approach to this issue and grant public companies some choice regarding the scope of director liability. This change was motivated by the rise in D&O insurance premia in the 1980's, which in turn was partially attributed to the increase in the rate and success of shareholder litigation against directors.[34] This D&O insurance "crisis" was exacerbated by the Delaware Supreme Court decision in *Smith v. Van Gorkom,* which signaled greater willingness by courts to find violations of directors' duty of care. All this led to a widespread concern that companies might be unable to attract qualified individuals to serve on their boards of directors.[35]

To alleviate these concerns, Delaware, followed by a majority of states,[36] decided to make it possible for companies to have limited liability for their directors' duty of care violations. Under this enabling approach, companies have contractual freedom to choose between: (i) eliminating the personal monetary liability of their directors for duty of care violations, and (ii) having their directors personally liable for such violations. Below, we take

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[33] Both the duty of care and the duty of loyalty were mandatory. *See* Eisenberg, *supra* note 14 (highlighting the mandatory nature of the duty of loyalty); R. Franklin Balotti & Mark J. Gentile, *Commentary From the Bar: Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 10-11 (1987) (emphasizing that statutory amendments were required to allow companies to limit their directors' liability for breaching the duty of care).

[34] *See* Roberta Romano*, Corporate Governance in the Aftermath of the Insurance Crisis, 39* EMORY L.J. 1155, 1157-60 (1990) (reviewing the D&O liability insurance crisis and its connection to corporate litigation).

[35] *See* Balotti & Gentile, *supra* note 33, at 9; Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance,* 75 IOWA L. REV. 1, 42-43 (1989).

[36] The majority of states amended their statutes to relax the rules governing director liability. *See* Romano, *supra* note 34, at 1160 (noting that "[w]ithin two years, forty-one states, including those with the largest public corporations, amended their corporation statutes to reduce directors' liability exposure").

the adoption of this larger menu as given, and focus only on the choice of the default for existing companies.[37]

Having decided to subject the issue to contractual freedom, Delaware had to determine which arrangement would serve as the default. Specifically, Delaware faced a choice between at least two alternative regimes. One possible approach was to adopt an *opt-in* regime; under this regime, the old, "strict " arrangement would serve as the default, and companies wishing to limit director liability would have to opt out to this effect by amending their charter. An alternative approach was to adopt an *opt-out* regime; under this regime, the new, "lenient" arrangement would serve as the default, and companies wishing to have personal liability for duty of care violations would have to opt out via a charter amendment.

Delaware, and most of the other states that introduced the option of limiting director liability,[38] followed the first approach and adopted an opt-in regime. Section 102(b)(7) of the Delaware statute permits companies to include in their charter a provision abolishing the directors' monetary liability for duty of care violations.[39] As to companies whose charter does not include a provision limiting directors' liability, their directors face full personal liability for duty of care violations. In contrast, some states, such as Ohio,[40] followed an opt-out approach

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[37] Several states chose to limit managerial liability in a mandatory fashion. Indiana, for example, adopted a mandatory provision changing the basis of liability for breaching the duty of care from gross negligence to willfulness or recklessness. *See, e.g.*, IND. CODE ANN. §23-1-35-1(e) (West Supp. 2001); Romano, *supra* note 34, at 1160 (interpreting the Indiana provision as a mandatory one). Our analysis, focusing on the optimal approach to designing default rules, does not apply to the legislation of these states.

[38] By 1990, approximately 30 states adopted the Delaware model. *See* Committee on Corporate Laws, *Changes in the Revised Model Business Corporation Act-Amendment Pertaining to the Liability of Directors,* 45 BUS. LAW. 695, 696 (1990). Only a handful of companies adopted the opt-in model. *See id.*at 697.

[39] DEL. CODE ANN. tit. 8, § 102(b)(7) (1991).

[40] *See, e.g.*, OHIO REV. CODE ANN. § 1701.59(D) (West Supp. 2000) (abolishing, unless the articles specifically state otherwise, director monetary liability for acts undertaken not with intent to cause injury to the corporation or with reckless disregard to its interests).

under which directors do not have personal liability for duty of care violations unless there are charter provisions to the contrary.

Evaluating the issue from the perspective of the reversible defaults approach, the opt-in route followed by Delaware and most other states allowing for limits on liability was indeed the desirable one. To see this, consider first the consequences of adopting an opt-out regime assuming the default rule this regime imposes – the lenient arrangement of no personal liability for duty of care violations - turns out to be the one shareholders disfavor. In such a regime, even though shareholders would clearly support a charter amendment opting-out into the stringent arrangement, the board might well not initiate such an amendment. Though, by hypothesis, such an amendment would increase shareholder value, directors will weigh their stake in the expected increased value of the corporation against the increase in their expected liability costs. Accordingly, since directors might want to keep the no-liability arrangement, the value-enhancing arrangement might not be adopted.

Consider in turn the consequences of an opting-in regime under which a no-liability arrangement is allowed but only if the charter includes a provision to this effect. Under this regime, whenever the default arrangement of director liability is disfavored by shareholders as compared with the no-liability arrangement, the latter can be expected to be adopted. Shareholders would support a charter amendment because, by hypothesis, this amendment would increase the value of their shares. Directors would eagerly support this amendment because it not only would increase share value, but also would (perhaps even more importantly for them) reduce their liability exposure.

Indeed, the large number of companies in Delaware and in other states that in fact chose to opt into a no-liability arrangement exemplifies the ease with which opt-out charter provisions can be adopted when managers favor the opting out of the default arrangement.[41] The asymmetry in the ease with which the two alternative defaults could be reversed justifies the use of the opt-in route because, when states adopted the considered legislation, lawmakers could not have been confident that abolishing duty-of-care liability would be generally value-enhancing for corporations. Given this uncertainty, the opt-in regime Delaware adopted was indeed the route that was desirable according to the reversible defaults approach.

It might be argued that the decisions by the majority of companies to limit the duty-of-care liability of their directors cast serious doubts on the wisdom of states' past decisions to adopt opt-in regimes. After all, so the argument goes, the large number of companies that chose to have a regime limiting duty-of-care liability indicates that such a regime should have been viewed as clearly the desirable one. We find this argument, however, to be unpersuasive.

To begin, not all companies abolished their directors' liability, and states' adoption of an opt-in regime is what made it possible to maintain directors' liability in those companies whose shareholders favored such an arrangement. Furthermore, in evaluating the wisdom of adopting an opt-in regime, what matters is not which arrangement is viewed as best in hindsight. Rather, the important question is whether state legislators, at the time that they had to decide which default to choose, could have identified with certainty one arrangement as the value-maximizing one for all, or almost all, companies. Thus, as long as a sufficient level of such uncertainty

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[41] *See* Romano, *supra* note 34, at 1160-61 (reporting that over 90 percent of her sample of Delaware companies adopted exculpatory provisions). *See also* Lawrence A. Hamermesh, *Why I Do Not Teach* Van Gorkom, 34 GA. L. REV. 477, 490 (2000) ("[O]ut of one hundred 'Fortune 500' companies, ninety-eight of the stock corporations that incorporated in jurisdictions allowing for exculpatory charter provisions have adopted such provisions."). We are unaware of empirical studies specifically focusing on the number of mid-stream companies that amended their charter to limit the liability of their directors for duty of care violations.

existed when states chose the default arrangement, adopting an opt-in regime indeed was the desirable route to follow according to the reversible defaults approach.[42]

B. State Antitakeover Statutes

We now turn to examine the choices of default arrangements involved in state antitakeover legislation. By 2000, forty-two states had enacted some form of statute regulating takeover bidders.[43] We focus in this Section on the so-called "bidder-restriction" statutes, which impose various restrictions on bidders. Examples of bidder-restriction legislation include "business combination" statutes, which prohibit successful bidders from engaging in certain business combinations with an acquired company, and "control share acquisition" statutes which require a shareholder vote approving the "acquisition of control" by the bidder.[44]

States have generally elected to leave companies with some contractual freedom with respect to the takeover regime governing them. The vast majority of bidder-restriction statutes allow companies to opt out of the default arrangement they set.[45] We do not intend in this Section to question basic justifications for having state antitakeover statutes and, in particular, for allowing companies to have a regime substantially restricting takeovers.[46] Rather, we take as

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[42] For the formal conditions specifying what would be a "sufficient" level of uncertainty for our purposes, see our general analysis *supra* Part II.C.4.

[43] *See* GRANT A. GARTMAN, STATE TAKEOVER LAWS, App. A-5 (2000).

[44] For a review of the main groups of antitakeover provisions, see JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS, 1092-97 (5th ed. 2000); GARTMAN, *id.*

[45] We do not discuss another group of statutes with antitakeover effects–constituency statutes. This is because these statutes, apparently enacted to protect the interest of third parties, are mandatory in nature. For a comprehensive discussion of these statutes, see Frank J. Garcia, *Protecting Nonshareholder Interests in the Market for Corporate Control: A Role for State Takeover Statutes,* 23 U. MICH. J.L. REFORM 507, 526-534 (1990).

[46] For a critique of state antitakeover statutes, see Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1174-77 (1999) [hereinafter Bebchuk and Ferrell, Race to Protect Managers]; Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L.

given the decision by states to offer a menu that includes an option of a regime restricting bidders, and we only examine the choice by states of the default arrangement that would apply absent a charter provision indicating otherwise.

Again, states could have followed two alternative routes. First, states could maintain an opt-in regime under which the default arrangement would not impose restrictions on bidders but a regime with such restrictions could be introduced by opt-in charter provisions. Alternatively, states could have adopted an opt-out regime under which the default would impose restriction on bidders but companies would be allowed to opt out of this regime.

As in the director liability context, whereas the choice of the default rule did not have a substantial and irreversible impact on future IPOs, it was of considerable importance for companies already in existence.[47] Furthermore, states could not have been confident that their bidder-restriction rules would be value maximizing for all corporations. In the presence of such uncertainty, the reversible defaults approach called not for adopting as default the regime restricting bidders and thus favored by managers, but rather for enabling shareholders to opt into this regime.

Consider the consequences of adopting a default rule imposing bidder restrictions assuming that these restrictions turn out to be value-reducing because they excessively deter bidders. In such a case, even though shareholders would support a charter amendment opting out of these restrictions, the board might well not initiate such an amendment. Notwithstanding the

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REV. 111 (2001) [hereinafter Bebchuk and Ferrell, A New Approach]. The empirical evidence indicates that the passage of antitakeover statutes was largely accompanied by either no effect or negative effect on shareholder value. For a survey of this evidence, see Gartman, supra note 43.

[47] Indeed, in many cases states adopted antitakeover provisions to affect pending hostile takeover battles. *See* Henry N. Butler, *Corporation-Specific Anti-takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365; GARTMAN, *supra* note 43, at Massachusetts-4 (attributing the rapid enactment of the Massachusetts antitakeover statute to a pending hostile takeover for Gillette.).

default arrangement's adverse effect on shareholder value, managers might prefer this arrangement because it would benefit them by weakening the threat of hostile bids and thereby strengthening their hold on control.[48] As a result, bidder-restriction defaults might persist even when they turn out to be inefficient.

In contrast, the alternative default choice, under which state law would not impose a regime with bidder restrictions absent a charter provision to this effect, would generally produce desirable outcomes even if the chosen default turns out to be inefficient. In such a case, shareholders would support an opt-in amendment and the managers would be more than happy to initiate it and bring it for shareholder approval. Thus, a default without bidder restrictions would be replaced readily whenever it turns out to be disfavored by shareholders.

Given this asymmetry in reversibility between the two alternative defaults, states should have adopted opt-in regimes under which the bidder restrictions would prevail only if companies adopt charter provisions to this effect. As an acceptable alternative, states could have adopted as default a regime imposing bidder restrictions while enabling companies to opt out of this default through bylaw provisions.[49]

States, however, met the challenge of choosing defaults in this area with varying degrees of success. Virtually all states adopting bidder-regulations provisions enacted an opt-out regime, that is, they adopted bidder-restriction provisions as the default regime.[50] States differed, however, in the procedures they set for opting out. Several states, including Delaware and New

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[48] *See* Lucian Arye, "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law,": 105 Harvard Law Review 1435 (1992); Bebchuk and Ferrell, Race to Protect Managers, supra note 46; Oren Bargil, Michal Barzuza, and Lucian Bebchuk, "A Model of the Market for Corporate Law," (working paper, 2001), Harvard Law School, available on www.ssrn.org.

[49] *See* our discussion of bylaw amendments *infra* Part II.C.5.

[50] For a review of the default rules states adopted and the procedural requirements for opting out, see GARTMAN, *supra* note 43.

York, allow corporations to opt out of their business combinations statutes through bylaw provisions supported by a majority of the outstanding shares.[51] As indicated earlier, such an arrangement is largely consistent with the reversible defaults approach.[52]

In an action inconsistent with the reversible defaults approach, some other states allow companies to opt out also through bylaw provisions, but make opting out in this way difficult by imposing tough supermajority requirements. Connecticut, for example, allows corporations to opt out of its business combinations statute by charter or bylaw amendment approved by two-thirds of the shares not owned by a ten-percent shareholder.[53] Maryland goes further and requires, for opting out of its business combinations statute through a bylaw amendment, an approval by at least 80 percent of the outstanding shares.[54] Such supermajority requirements increase the costs, and reduce the likelihood, of opting out of inefficient default rules without the board' cooperation. Indeed, given the substantial incidence of non-participation in corporate votes,[55] highly demanding supermajority requirements, such as Maryland's eighty percent of

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[51] *See* DEL. CODE ANN. tit. 8, § 203; N.Y. BUS. CORP. LAW § 912 (McKinney Supp. 2001). New York introduces an additional constraint. If the bidder holds more than 20% of shares at the time of the vote, the opting out must be approved by a majority of outstanding shares not owned by the bidder. There is another constraint on the ability to opt out: shareholder opting-out becomes effective only after 18 months and would not apply to 15% shareholders at the time of the vote. These constraints are aimed at enabling a bidder to bypass the protection the statute grants by acquiring shares and then using them to opt out.

[52] *But see* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW, 56-57 (1993) (expressing a clear preference for opting-out arrangement over opting-in arrangement even in the absence of supermajority requirement due to the collective-action problem characterizing shareholder action).

[53] *See* CONN. GEN. STAT. ANN. §§ 33-843 to 33-845 (West 1997). *See also* OHIO REV. CODE ANN. §§ 1704.01-1704.07 (West 1994) (imposing similar supermajority requirements on charter amendments when opting out of its "business combination" statute.)

[54] *See* MD. CODE ANN., CORPS & ASS'NS §§ 3-601 to 3-604 (1999).

[55] *See id.* These supermajority requirements practically eliminate shareholders' ability to opt out because a significant percentage of shares are not voted in proxy contests. *See* James Brickley et al. *Ownership Structure and Voting on Antitakeover Amendment*, 20 J. FIN. ECON. 267 (1988) (reporting that, in their sample of 288 corporate votes, the mean fraction of shares that were not voted was 13.8%); Philip J. Young et al., *Trading Volume, Management Solicitation, and Shareholder Voting,* 33 J. FIN.

outstanding shares, practically eliminate shareholders' ability to opt out by amending the bylaws. As a consequence, under these supermajority requirements, shareholders do not practically have a way of opting out without management consent.[56]

Finally, several states preclude companies from opting out through bylaw amendment and allow opting out only through charter provisions.[57] Indeed, some states not only require charter amendment for opting out but also impose supermajority requirements on the approval of such a charter amendment.[58] With or without a supermajority requirement, the charter amendment route does not enable shareholders to opt out without managers' cooperation. Thus, the route taken by these states is also inconsistent with the reversible defaults approach.

C. The Poison Pill

Poison pills consist of stock warrants or rights that, as long as the company has not redeemed them, make the acquisition of a control block by a hostile bidder prohibitively expensive.[59] The poison pill was invented in the 1980s to assist boards in resisting hostile

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ECON. 57 (1993) (reporting that the mean fraction of shares not voted in their sample of 343 proposals was 19.45%).

[56] States' decision to impose supermajority requirements on shareholder opt-out is particularly puzzling considering the fact that that many states impose different majority requirements for opting out of different antitakeover provisions, without any apparent justification for these different treatments. Maryland, for example, which imposes supermajority requirements on the vote to opt out of its business combination and fair price statute, imposes no such requirements on the vote to opt out of its control share acquisition statute. *See* MD. CODE ANN., CORPS & ASS'NS §§ 3-601 to 3-604 and §§ 3-701 to 3-709 (1999).

[57] *See, e.g.*, HAW. REV. STAT. ANN. §§ 415-171 to 415-172 (Michie 1997) (opting out through charter amendment only).

[58] Kentucky requires a charter amendment supported by 80 percent of the shares entitled to vote. *See* KY. REV. STAT. ANN. §§ 271B.12-200 to 271B.12-230 (Michie 1989); Louisiana imposes an identical requirement with respect to its "fair price" statute. *See* LA. REV. STAT. ANN. §§ 12:132-12:134 (West 1994).

[59] For a description of the common features of a poison pill, see Wachtell, Lipton, Rosen & Katz, *The Share Purchase Rights Plan*, *reprinted in* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, at 4-12 (2d ed. 1998 Supp.). For a description of how a pill

takeovers. The pill's inventors took advantage of statutory provisions that gave boards the formal power to design and issue securities.[60] While this formal power had been used earlier to provide flexibility in the raising of capital, the creators of pills sought to use it for antitakeover purposes. Thus, the question that courts faced was whether such a new use of this formal power to create poison pills is consistent with managers' fiduciary duties or, more generally, with managers' role in the corporation.

Because the pill was a new tool that corporate planners had not anticipated earlier, public officials had to choose a default arrangement to govern it.[61] Given the uncertainty that courts and legislators faced on the question of whether poison pills would enhance shareholder value, they could have followed two alternative routes. First, they could have adopted an opt-in regime under which companies could use poison pills only if shareholders ratified the pills or approved a charter provision allowing such pills. Alternatively, public officials could have chosen an opt-out regime, under which the board would be authorized to adopt a pill unless the charter explicitly prohibited it from doing so.

Under the reversible defaults approach, the optimal default arrangement would not allow management to adopt a poison pill without shareholder ratification or a charter provision.[62] The reasoning underlying our position here is similar to the one used in examining state antitakeover

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works, see John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 287 n.62 (2000).

[60] *See* DEL. CODE ANN. tit. 8, § 157; Moran v. Household International, 500 A.2d 1346, 1351 (Del. 1985).

[61] We share the view of Daines and Klausner that, in states that allow the board to adopt poison pills, a charter provision disallowing the adoption of a pill would be valid and enforced. *See* Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs,* 17 J. LAW ECON. & ORG. 83 (2001). Assuming this is the case, then the choice that courts faced was indeed one of the desirable default arrangement.

[62] *See also* Bebchuk & Ferrell, Race to Protect Managers, *supra* note46, at 1189-90 (arguing that, given the uncertainty over the desirability of poison pills, states should have required management to get shareholder consent before adopting a poison pill).

statutes. Because the effect of poison pills on shareholder value was uncertain, public officials should have taken into account the asymmetry in the ease with which the two alternative defaults could be reversed. Like other rules governing takeovers, rules governing the adoption of poison pills have a clear effect on managers' interests because they affect the likelihood of successful hostile takeovers. Consequently, companies could not have been expected to opt out of a default arrangement allowing poison pills even if this arrangement would not serve shareholder value. In contrast, under a default arrangement making shareholder consent necessary for pills, shareholders could have been expected to give such consent if pills would turn out to serve shareholder value.

State corporate laws, however, have not followed the optimal route. States have generally adopted an opt-out regime under which the default rule allows managers to adopt pills without shareholder approval.[63] Moreover, when several state courts ruled that boards lacked the power to adopt a pill unilaterally, lawmakers quickly changed state statutes to negate such rulings and explicitly provide boards with such power.[64]

Finally, it might be argued that it is inaccurate to view state law as imposing a regime with poison pills without providing shareholders with an effective way out. Shareholders have an effective way out, so the argument goes, because they can always overcome a poison pill by

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[63] Some state statutes explicitly grant their poison pill endorsement provisions a default status. *See, e.g.*, VA. CODE ANN. § 13.1-646 (Michie 1999) (subjecting the board power to adopt poison pills to contrary provision in the charter); WASH. REV. CODE § 23.B.06.240 (1994) (same). Other statutes do not specify whether their poison pill endorsement is mandatory or default. *See, e.g.,* MASS. ANN. LAWS ch. 156B, § 32A (Law. Co-op. 1996). We doubt that these silent poison pill endorsement statutes would be interpreted as mandatory. Nevertheless, it should be clear that our analysis applies to these statutes only to the extent they adopt default arrangements.

[64] *See* CHARLES R.T. OAKLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 844 (3d ed. 1999) (noting that "in each case in which a court has challenged the board's authority to enact a poison pill, the affected state's legislature has followed with a statute authorizing the pills").

electing a new board that would dismantle the pill. However, although a poison pill indeed cannot fully block hostile takeovers, this argument does not establish that a regime with pills facilitates takeovers to the same extent as a regime without them. In particular, replacing a board via elections might be a costly process that is not a perfect substitute for a straight tender offer. Finally, as we now turn to discuss, whereas poison pills by themselves do not create substantial antitakeover impediments, they might do so when combined with antitakeover charter provisions ("ATPs").

D. Pills with ATPs

Although they might be costly to overcome, pills cannot by themselves considerably impede a bidder whose offer would be attractive to shareholders. As the board generally has the power to redeem a poison pill, a hostile bidder can succeed in its bid by first obtaining control of the target's board and then redeeming the pill to enable the bid to proceed.[65] Having a poison pill by itself simply amounts to requiring a hostile bidder to win a proxy contest that would essentially serve as a referendum on its offer. A poison pill can serve as a serious impediment to a takeover, however, when a company has one or more ATPs that delay the replacement of directors via a proxy contest. The combination of a pill with such ATPs can impede hostile bidders with offers that could be attractive for shareholders. We focus below on the most powerful ATP: the one establishing a classified board. Our analysis, however, is relevant also to other types of ATPs.

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[65] Efforts to cut off this line of attack by allowing only continuing directors to redeem the pill (so-called "dead hand" provisions) or delaying redemption for a specified period of time after a change in board composition ("no hand" or "slow hand" provisions) were invalidated by the Delaware courts in the late 1990s. *See* Quickturn Design Systems v. Shapiro, 721 A.2d 1281 (Del. 1998) (invalidating "no hand" pill); Carmody v. Toll Bros., 723 A.2d 1180 (Del. Ch. 1998) (rejecting defendant's arguments for the validity of a dead hand pill).

1. *Shareholder Consent for Antitakeover Protections Produced by Classified Boards*

Classified boards provide a powerful antitakeover device because they substantially impede a hostile bidder's ability to gain control of the board and redeem the pill.[66] A company with a classified board groups directors into classes (typically three) with each class elected at a successive annual meeting. With an effective classified board,[67] gaining control of the board would require winning at least two elections. Thus, no matter how close to an annual election it emerges, a hostile bidder would be unable to gain control without fighting for it for more than one year. This minimum delay of one year in gaining control creates a costly and substantial impediment for a hostile takeover. In addition to the problem of delay, hostile takeovers are also impeded by the need, when facing an effective classified board, to win two separate elections for the board, one year apart.

Recognizing that the combination of poison pills and classified boards creates a powerful antitakeover defense, it might be still suggested that this use of classified boards is supported by shareholder consent. Classified boards, so the argument goes, require a charter provision, which cannot exist without obtaining implicit or explicit shareholder consent. For such a charter provision to exist, it either had to have been included in the initial charter known to public investors that subsequently purchased shares in the company, or it had to have been introduced as a charter amendment upon approval by a shareholder vote. As explained below, however,

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[66] See Bebchuk, John C. Coates IV & Guhan Subramanian., *The Antitakeover Power of Classified Boards: Theory, Evidence, and Policy,* STAN. L. REV. (forthcoming, 2002). This study analyzes the special antitakeover power of classified boards. The study also finds that the evidence is consistent with this analysis; having an effective classified board is shown to increase substantially the likelihood that a target receiving a hostile would remain independent.

[67] By "effective classified board" we mean a classified board that cannot be dismantled through the removal of directors without cause or the packing of the board. *See* John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?,* 24 J. CORP. L. 837, 840 (1999).

whether the antitakeover use of classified boards can be viewed as grounded in shareholder consent depends on when the classified board was adopted. [68]

Before the introduction of the poison pill, the classified board was a fairly mild takeover defense mechanism.[69] During that period, a classified board could not prevent a bidder from acquiring a controlling block, and it was generally believed that the board would resign if a bidder were to acquire a controlling block, making an ultimate replacement of the board inevitable (though not imminent). Even after the pill's introduction and its legal endorsement in the *Moran* decision,[70] its full effect on the defensive power of classified boards did not become clear until around 1990. In a series of decisions between the years 1985 and 1989,[71] Delaware courts indicated that they might limit the ability of managers to maintain a pill indefinitely and might require managers to redeem a pill once it outlives its usefulness for shareholders.[72] Classified boards obtained their full antitakeover significance only following the decision of the Delaware Supreme Court in *Paramount,*[73] which transformed what was a qualified right to use

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[68] This mid-stream problem, resulting from the adoption of charter provisions prior to the doctrinal developments that provided them with considerable antitakeover significance, was first examined by Bebchuk and Ferrell, Race to Protect Managers, supra note 46, and Bebchuk and Ferrell, A New Approach, supra note 46.

[69] *See* ROBERT C. CLARK, CORPORATE LAW 576 (1986) (listing classified boards among takeover defenses but characterizing them as fairly weak). For an extensive analysis of the developments in the antitakeover effects of classified board, see Lucian A. Bebchuk et al., *supra* note 65, at 14 (manuscript).

[70] Moran v. Household International, 500 A.2d 1346 (Del. 1985) (recognizing the power of the board to adopt a poison pill).

[71] *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (enjoining asset lockup and other defensive actions); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986) (enjoining defensive recapitalization); City Capital Assocs. v. Iterco Inc., 551 A.2d 787 (Del. Ch. 1988) (holding that a pill had to be redeemed because its use to resist a non-coercive tender offer was not proportionate to any threat posted by the tender offer); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989) (enjoining management buyout).

[72] During this period, managers were no doubt motivated by the threat of a hostile takeover in proposing classified boards. Shareholders, meanwhile, generally approved classified boards during this period because a hostile bidder still had a viable route against a disloyal target board.

[73] Paramount Communications v. Time, 517 A.2d 1140 (1989).

the pill into a seemingly absolute right for managers to "Just Say No" as long as they are in office. Subsequent cases, such as *Wallace Computer,* have further demonstrated that courts will allow incumbents to maintain a pill and resist a hostile bid indefinitely, and that the only way for a hostile bidder to succeed is by first winning control of the board.[74]

Indeed, this major transformation in the entrenching power of classified boards had a marked effect on institutional investors' voting practices. Until the late 1980, institutional investors were quite willing to vote in favor of charter amendments classifying the board. But during the 1990s, institutional investors' support for such amendments vanished, and management proposals to classify boards dropped from 90 proposals in 1988 to just nine proposals in 1998.[75] In fact, proposals for an advisory resolution calling for a *declassification* of the board have been drawing substantial support among shareholders since the beginning of the 1990s.[76]

Thus, shareholders who accepted classified boards prior to 1990, either by buying shares of companies that already had a classified board or by approving a charter amendment to classify the board, did not contemplate the subsequent development of the pill and its consequences for the potentially entrenching power of classified boards. This implies that these shareholders should not be regarded as having consented to be governed by the strong antitakeover protection that can be produced by a combination of a pill and a classified board. The nature of the default

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[74] Moore Corp. v. Wallace Computer Servs., 907 F. Supp. 1545 (D. Del. 1995) (holding that the business judgment rule protects a target's board in its "Just Say No" defense against a hostile bid). *See also* Neil C. Rifkind, Note, *Should Uninformed Shareholders Be a Threat Justifying Defensive Action by Target Directors in Delaware?: "Just Say No" After Moore v. Wallace,* 78 B.U.L. REV. 105 (1998).

[75] *See* Bebchuk, Coates, and Subramanian, *supra* note 65, at 57 (September 2001 manuscript).

[76] *See* Coates, *supra* note __, at 861 table 5.

rules governing these shareholders is of considerable practical importance since eighty-four percent of companies with classified boards adopted them prior to 1990.[77]

2. *Applying the Reversible Defaults Approach*

Having seen that the antitakeover implications currently associated with a classified board arose from developments in poison pill doctrine that had not been reasonably anticipated earlier, we now turn to apply the reversible defaults approach. Given these developments, what approach should have been taken with respect to all the companies that adopted a classified board prior to these developments?

The reversible defaults approach called for the adoption of an opt-in arrangement under which the law would have required shareholders' opting-in for this new and powerful antitakeover device to govern them. Adopting an opt-out arrangement, that is, adopting a regime allowing companies to use this device even when such regime did receive a genuine shareholders support might lead, for reasons we have discussed, to the persistence of an arrangement shareholders disfavor. State corporate law, however, did follow such an opt-out regime, effectively imposing a powerful antitakeover device on shareholders who had not earlier anticipated it or consented to it. The route taken by state corporate law in this matter is thus inconsistent with the reversible defaults approach.

We wish now to outline two ways in which the reversible defaults approach could be applied going forward to ensure that shareholders are not subject, without their genuine consent, to a powerful antitakeover device. The first alternative would apply to companies with classified

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[77] *See* Bebchuk, Coates, and Subramanian, *supra* note 65, at 55, fig.7.

boards whose managers lost one proxy contest over an acquisition offer.[78] This alternative would not allow managers of targets with a classified board to keep blocking an offer after losing such a contest unless the classified board was adopted or ratified after 1990. This approach would provide substance to the Delaware Supreme Court's language in *Moran* that directors may not "arbitrarily reject" an offer made by a hostile bidder.[79] This approach would have the benefit of fitting within the existing Delaware case law on defensive tactics.

The second alternative would allow shareholders to initiate and adopt bylaw amendments limiting the board's ability to adopt a poison pill. Though not fully equivalent to the optimal opt-in arrangement, this approach would grant shareholders, rather than the board, the effective ability to opt out of entrenching classified boards. In cases of companies with classified boards, if shareholders were to adopt such a bylaw provision and thereby eliminate the potential use of a poison pill, the antitakeover significance of the classified board will return to its mild pre-1990 level. Indeed, a recent decision by the Supreme Court of Oklahoma recognized the power of shareholders to adopt provisions of this type in the bylaws.[80] Although Delaware courts have not yet addressed this question, the emerging consensus among practitioners and the S.E.C. is that they would be unlikely to uphold shareholder attempts to adopt such provisions.[81]

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[78] This is the proposal made for classified boards by Bebchuk, Coates, and Subramanian, supra note 65. We endorse it here as consistent with the reversible defaults approach.

[79] *See* Moran v. Household International, 500 A.2d 1346, 1354 (Del. 1985).

[80] Int'l Bhd. of Teamsters Gen. Fund v. Fleming Cos., 975 P.2d 907 (Okla. 1999)

[81] *See* John C. Coates IV & Bradley C. Faris, *Second-Generation Shareholder Bylaws: Post-*Quickturn *Alternatives*, 56 BUS. LAW. 1323, 1326-27 (2001) (reporting that the Staff of the SEC has allowed companies to exclude proposals for such bylaws from company proxy statements under Rule 14a-8). Coates and Faris rely on the decision by the Delaware Supreme Court in *Quickturn Design Systems, Inc., v. Shapiro*, 721 A.2d 1281, 1291-92 (Del. 1998), in which the court struck down a no hand pill because it restricted the "board's power in an area of fundamental importance to the shareholders – negotiating a possible sale of the corporation." *See also* Charles F. Richards, Jr. & Robert J. Stearn, Jr., *Shareholder By-laws Requiring Boards of Directors to Dismantle Rights Plans Are Unlikely to Survive Scrutiny Under Delaware Law*, 54 BUS. LAW. 607 (1999).

Our analysis, however, suggests that, at least with respect to companies with pre-1990 classified boards, such bylaw provisions could address an important problem.

V. Conclusion

In this paper, we have developed a reversible defaults approach for the choice of default rules as corporate law evolves. When choosing defaults, we have argued, it is important to take into account the asymmetry introduced by management control over charter amendments. Under the proposed approach, public officials should err in favor of choosing defaults that are more restrictive with respect to managers. Following such an approach would make it most likely that the value-maximizing arrangement would ultimately govern shareholders. We have used the proposed approach as basis for evaluating some of the main choices that state corporate law has made -- some well and some not well -- in the last two decades. This approach can similarly provide a good basis for evaluating and making such choices as corporate law continues to evolve, as it must do, in the future.