THE POWER TO ISSUE STOCK

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ABSTRACT

Studies of management's disregard of the will of the shareholders have focused on combinations of entrenchment mechanisms and special governance structures. However, management's power to issue stock—a fundamental element of the ability of management to control the corporation regardless of the will of the shareholders—has received scarce attention. This Article highlights the significance of the power to issue stock: when managers choose to ignore the will of the majority of the shareholders or when managers choose to circumvent the veto power of the minority shareholders, they often take advantage of their power to issue stock. A top-up option, for example, which is studied in this Article, is contingent upon the managers' ability to issue shares and dilute the voting power of the dissenting minority shareholders. The poison pill is also contingent upon the managers' ability to dilute a hostile bidder by issuing shares to the shareholders. The ability of managers to use new stock issuances as a shareholder-circumventing mechanism is particularly important. It plays a key role in the management's arsenal and provides an incentive for managers to reserve this unique power and refrain from diminishing it by, for example, replacing equity-based compensation and equity financing with less efficient choices. This Article explores the key power of managers to issue stock as well as the current and potential limitations on this power. One such limitation is the size of the authorized capital of the corporation, which provides a ceiling for the total number of shares that can be issued. The ratio of authorized non-outstanding shares to the issued

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and outstanding shares—what I shall call the "excess ratio"—is an indicator of the magnitude of the managers' power to issue stock. A study of the excess ratio reveals that corporations go public with a high excess ratio—the number of unissued authorized shares is more than three times the number of issued shares. Further results of the study of the excess ratio are analyzed in this Article.

INTRODUCTION

A company's board of directors is entrusted with the power to issue stock. Shareholder approval is usually not required for this basic managerial prerogative.[1] Conventional issuances of stock by the board of directors generally serve valid business goals, such as financing the firm's operations and motivating employees. Raising funds for the company's operations can be done through equity financing in which the investor gives the company money in exchange for an equity stake in the company. Aligning the interests of recipients of the issued stock, such as employees and service providers, with the interests of the company is another business-driven motivation to issue stock.

A direct outcome of any issuance of shares is the dilution of existing shareholders. Voting dilution occurs when the existing shareholder owns a lower percentage of the company than she had before the new issue of stock, and thus her voting rights represent a lower percentage of the total shareholder votes. Voting dilution can occur even if the value of the shares of the existing shareholder remains the same and is undiluted by the issuance of new shares. If the new shareholder purchases her shares for a fair consideration, it does not affect the value of the existing shareholders. The voting rights of the existing shareholder, however, will be diluted if she does not participate in the new issuance pro-rata to her percentage holding prior to the issuance. After the issuance of new shares, the old shareholder possesses a smaller percentage of the company, yet the company is worth more.[2] If the consideration received for the new shares is lower than the intrinsic fair value of these shares, then the economic value of the old shareholders is diluted and their stake in the company is worth less after the issuance of the new shares.

This byproduct of issuing new shares, diluting the existing shareholders, can become the intended outcome of the managers. They can use their power to issue shares to dilute the voting rights of the shareholders or to dilute the economic value of shares. The

1. DEL. CODE ANN. tit. 8, § 161 (2010). For limitations of this right, see *infra* Part I.D. In addition, specific contractual requirements may also require a shareholder approval on specific share issuances.

2. This is because the total value of the company increases by the value of the added consideration that the company receives for the newly issued shares.

managers can take advantage of this power to dilute shareholders to advance inefficient self-promoting goals. Using the power to issue shares to circumvent the voting power of the shareholders can take several forms.

Perhaps the most common and renowned use of the power to issue shares is the poison pill. Poison pills refer to shareholder-rights plans that enable managers to thwart a hostile takeover.[3] These rights plans allow the existing shareholders, but not the raider, to acquire a substantial amount of new shares at an exceptionally low cost.[4] The expected result of the poison pill, the dilution of the economic value of the raider, serves as a deterrent to a hostile raider. The managers' ability to dilute the hostile bidder prevents the takeover and entrenches the managers despite the support of the shareholders who may favor the hostile takeover.

The combination of several entrenchment mechanisms, and in particular the existence of a staggered board along with a poison pill, is especially effective in preventing a hostile takeover, even if the shareholders favor the acquisition.[5] Yet, even a poison pill by itself can stop hostile takeovers. For example, a poison pill helped Yahoo's management in the famous failed attempt by Microsoft to complete a hostile takeover of Yahoo.[6] Yahoo's poison pill enabled its managers to dilute a hostile bidder by issuing cheap shares to the existing shareholders only.[7] This poison pill rendered the takeover economically prohibitive ex ante.

The poison pill, along with a few other entrenchment mechanisms, has been at the center of the conventional focus of research on managers' efforts to entrench themselves.[8] The power to issue stock, a fundamental component of the poison pill, was not put at the center of the debate. It is the power to issue stock, however, that enables the managers to entrench themselves using anti-takeover mechanisms such as the poison pill and the white

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3. *Poison Pill*, FIN. TIMES LEXICON, http://lexicon.ft.com/Term?term=poison-pill (last visited Sept. 15, 2011).

4. *See, e.g.*, Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy,* 54 STAN. L. REV. 887, 904–05 (2002) (describing the poison pill). See *id.* at 905 n.59 for a discussion of the flip-in pill, which is the more common and potent version of the pill and *infra* Part I.B, discussing this version of the poison pill.

5. Bebchuk et al., *supra* note 4, at 903–04.

6. *See, e.g.*, John Letzing, *Yahoo Vulnerable if Microsoft Goes 'Hostile,'* MARKETWATCH (Feb. 11, 2008, 6:34 PM), http://www.marketwatch.com/story/story/print?guid=CB075A77-BD12-417C-B880-9063B4E0DEC4 (quoting Shirley Westcott of Proxy Governance) ("Yahoo has a 'poison pill,' and that pretty much blocks the consummation of any kind of tender offer.").

7. *Id.*

8. *See, e.g.*, Andrei Shleifer & Robert W. Vishny, *Management Entrenchment: The Case of Manager-Specific Investments*, 25 J. FIN. ECON. 123, 137 (1989).

squire[9] when shareholders are in favor of a sale. The power to issue stock also helps managers sell the company when they are personally interested in the sale despite significant shareholder opposition.[10]

Top-up options, for example, which are studied in this Article, are powerful tools that have increasingly been used to dilute the voting power of opposing shareholders in takeovers supported by the board of directors.[11] The grant of a top-up option as part of a takeover may allow for the consummation of a quick short-form merger without a shareholder meeting and despite the opposition of a significant number of the shareholders in excess of the statutory ceiling of ten percent of the shares.[12] The effect of a top-up option is that a management-friendly bidder faces only a truncated supply curve at the tender offer. This is because a top-up option lowers the percentage of shares needed to be tendered in order to have a successful outcome. In addition, the speed of the takeover process makes it harder for a competing bidder to launch an opposing bid. Like the poison pill, top-up options are contingent upon the managers' ability to issue a nontrivial number of shares and thus dilute the voting power of the dissenting minority shareholders.

Therefore, through new share issuances the managers have the ability to disregard the will of the shareholders and diminish the shareholder voting power. Managers can abuse this power for personal gain when they want to entrench themselves and prevent an efficient takeover of the company. This is the general criticism of mechanisms like poison pills and white squires[13] that can be used by self-interested managers to prevent a hostile takeover. Similarly, managers may want to push forward an acquisition despite significant shareholder opposition because the managers may stand to benefit from the transaction personally, either because they are related to the acquirer or because they expect to receive personal benefits from the sale, such as retention bonuses or perpetual

9. For a description and examples of the use of a white squire, see *infra* Part I.C.3.

10. *See generally, e.g.*, Mira Ganor, *Why Do Managers Dismantle Staggered Boards?*, 33 DEL. J. CORP. L. 149 (2008) [hereinafter Ganor, *Why Do Managers Dismantle Staggered Boards?*]; Mira Ganor, *Salvaged Directors or Perpetual Thrones?*, 5 VA. L. & BUS. REV. 267 (2010) [hereinafter Ganor, *Salvaged Directors or Perpetual Thrones?*] (suggesting managers at times prefer to sell the company to advance their own interests).

11. *See* Jim Mallea, *M&A Year End Review*, FACTSET MERGERS (Jan. 23, 2009), https://www.factsetmergers.com/marequest?an=dt.getPage&st=1&pg=/pub/rs_20090122.html&rnd=101994 ("In 2004, 35% of agreed tender offers included a top-up option. . . . In 2008, the inclusion of a top-up option had become standard as 100% of all agreed tender offers included one.").

12. DEL. CODE ANN. tit. 8, § 253 (2010).

13. For a description of the antitakeover mechanism known as a white squire as well as for an example of the use of a white squire to thwart a hostile takeover, see *infra* Part I.C.3.

thrones.[14]

To be sure, not all usages of the power to issue shares are inefficient and undesirable.[15] In addition to equity financing and equity compensation, even indirect business usages aimed at influencing the outcome of the shareholder vote, such as a poison pill or a top-up option, can be desirable given certain scenarios.[16] Yet, although there may be some cases in which managers' use of their power to issue stock in order to dictate the shareholder vote is efficient, the existence of this power to issue stock and its limits[17] are likely to influence managerial decisions in inefficient ways that are in part discussed in this Article.[18]

In particular, in an effort to maintain their power to issue stock, managers have an incentive to refrain from using stock for other business needs. This is because the managers' power to issue stock is limited and is mainly capped by the authorized capitalization set in the certificate of incorporation of the company.[19] As a result, managers have an incentive not to deplete the reserve of issuable shares, which may lead to excessive debt financing and overuse of monetary compensation.

This raises the question of whether or not the managers should have a restricted power to issue stock that would only allow them to issue stock for ordinary, nonorganic uses such as raising funds and aligning interests. The managers could be completely barred from issuing stock unilaterally, without the approval of the

14. *See generally* Ganor, *Why Do Managers Dismantle Staggered Boards?*, *supra* note 10; Ganor, *Salvaged Directors or Perpetual Thrones?*, *supra* note 10.

15. Several commentators support the use of a poison pill by arguing that the pill may help directors negotiate and reach a better outcome for the shareholders. *See generally, e.g.*, Stephen Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006); Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733 (2007); *see also* Ganor, *Salvaged Directors or Perpetual Thrones?*, *supra* note 10 (acknowledging that under certain circumstances, granting perpetual thrones can be efficient).

16. For example, a poison pill can be efficient where managers have nonpublic information that the company's prospects are much better than the market thinks and disclosing this information prematurely will hurt the company. Without this information being publicly available, a hostile bidder is likely to convince the shareholders to sell the company at a fraction of its true value.

17. *See infra* Part II.D (describing the limitations of the power to issue stock).

18. *See* Richard S. Markovits, *Monopoly and the Allocative Inefficiency of First-Best-Allocatively-Efficient Tort Law in Our Worse-Than-Second-Best World: The Whys and Some Therefores*, 46 CASE W. RES. L. REV. 313, 329–30 (1996) (discussing the general theory of Second Best, the deficiency of an isolated allocative-efficiency analysis without a study of the aggregate effects, and the applications of this theory to the law).

19. DEL. CODE ANN. tit. 8, § 102 (2010).

shareholders.[20] Conversely, should the managers be allowed to use the power to issue shares to influence the shareholders' vote without any limitation? In Maryland, for example, managers may be allowed to issue an unlimited number of shares for any purpose.[21]

In between these two extreme possible governance systems, there can be a policy that allows the managers to issue stock subject to certain limitations. For example, the current Delaware regime restricts the managers' power to issue stock and requires a cap on the total number of shares that can be issued without shareholder approval.[22] This cap has to be included as part of the company's certificate of incorporation.[23] A nuance of this regime links the maximum number of shares that can be issued without shareholder approval to the number of shares that are already issued by setting the maximum as a percentage of the number of issued shares.[24]

Preemptive rights represent another possible restriction on the power to issue stock. Preemptive rights allow the shareholders to participate in any issuance of shares pro rata to their percentage holding and thus can prevent dilution of the existing shareholders.[25]

The remainder of the Article proceeds as follows: Part I describes the shareholder power to issue shares, including the phenomenon of granting top-up options, and presents examples of such grants that illustrate the self-interest that has motivated these grants. Current limitations on the issuance of stock are described in this Part. Part I also examines the costs and benefits of the power while discussing possible incentive effects. Finally, the results of an empirical study of the excess ratio are presented in Part II, and the final Part concludes.

I. ISSUANCE OF SHARES

Stockholders' ownership of the corporation manifests itself in

20. *Id.*

21. For an example of a Maryland corporation that went public with a charter provision that allows its board of directors to issue an unlimited number of shares without shareholder approval, see UNDER ARMOUR, INC., PROSPECTUS 85 (Nov. 17, 2005), *available at* http://files.shareholder.com/downloads/UARM/494263049x0x60177/D03013EC-AECD-4604-8E42-C19ABD3F9CF2/S-111.17.05.pdf ("[Our charter] permits our board to amend the charter without stockholder approval to increase or decrease the aggregate number of shares of stock or the number of shares of stock of any class or series that we have authority to issue and to classify or reclassify unissued shares of stock.").

22. DEL. CODE ANN. tit. 8, § 161 (2010).

23. *Id.* § 102(a)(4).

24. *Cf.* NYSE, *Listed Company Manual* § 312.03(c) (2002), http://nysemanual.nyse.com; NASDAQ, *Corporate Governance Requirements*, http://www.nasdaq.com/about/nasdaq_listing_req_fees.pdf (stating that NASDAQ Rule 5635 requires shareholder approval for issuance of common stock equal to or greater than twenty percent of preissued shares subject to certain exceptions, such as a public offering).

25. *See infra* Part I.D.4 (discussing preemptive rights).

shares that give the stockholders various powers. Most notably, the shares are assigned the right to vote on certain resolutions and the right to transfer and sell the shares. Voting and selling shares are the conventional tools that stockholders have to control the managers and the corporation.[26]

The desirability and extent of the power of the shareholders to control the company through shareholder votes and sales of their stock has been vastly debated. Most notably, Lucian Bebchuk in his salient work on corporate governance calls for an increase in the shareholder power and a decrease in managerial control.[27] Other commentators have critiqued Bebchuk's view, raising doubts regarding the desirability of shareholder primacy.[28] In their renowned work, Henry Hu and Bernie Black exposed a major weakness of shareholder voting by demonstrating that share ownership and voting rights can easily be decoupled.[29]

Yet both the possibility of managers abusing their position as agents of the shareholders and the limits to the existing power of the shareholders to monitor the managers effectively are central to the quest of improving corporate governance, regardless of the answer to the question of the optimal level of shareholder control of the company. As this Article will show, the power to issue stock in its current format enables managers to circumvent the will of the shareholders and promote the managers' own self-interest at the shareholders' expense. To be sure, even opponents of the view that calls for enhanced shareholder power will support lowering agency costs and restricting self-enhancing and self-promoting managerial behavior that comes at the expense of the shareholders.

This Article focuses on strategic issuances of new shares in order to control the shareholder vote. This is an abuse of managers' power that creates agency costs by using the shareholder vote, the tool that is supposed to help shareholders monitor managers. Issuance of shares can help entrench the managers when the shareholders would rather sell the company.[30] When it serves the

26. There is evidence that managers can also be influenced by tools less conventional than regular voting on shareholder resolutions, such as vote-withholding techniques and voting on nonbinding, precatory resolutions. These tools also use the voting power assigned to the shares to pressure the managers to conform to the will of the shareholders. *See generally* Ganor, *Why do Managers Dismantle Staggered Boards?*, *supra* note 10.

27. *See generally* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

28. *See, e.g.*, Bainbridge, *supra* note 15; Lipton & Savitt, *supra* note 15.

29. *See generally* Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006).

30. *See, e.g.*, Andrew J. Opiola, *Should Shares Issued Directly From a Corporation Constitute a Control Share Acquisition?*, 1 J. BUS. & TECH. L. 207, 226 (2006).

self-interest of the managers, issuances of shares can also help sell the company despite significant opposition of shareholders who are not interested in selling.[31] As we shall see, the new shares may help the managers circumvent the will of the shareholders and promote the managers' own interests.

Issuance of new shares has a powerful effect on existing shareholders, as it dilutes their holdings. A shareholder's voting rights are diluted by the issuance of new shares unless she participates in the new issuance at least pro rata to her old percentage holding in the company and thus maintains at least the same percentage of the company as she did prior to the new issuance of shares. Issuance of shares can also result in an economic dilution of the existing shareholders. Economic dilution occurs when the value of the shareholder's stake in the company declines because of the newly-issued shares.[32] The value of the existing shares will decline when the consideration received for the new shares is lower than their true value.[33]

The following example illustrates the dilution effect. Suppose the value of a company is $100 and the shareholders of the company have a total of 100 shares. A new shareholder pays the company $50 in exchange for 100 newly-issued shares, a price of $0.50 per share. The new value of the company following the share issuance transaction is the sum of the old value of the company (i.e., $100) and the consideration the company received from the new shareholder (i.e., $50), equaling a total of $150.

The newly-issued shares give the new shareholder the rights to half of the company. The old shareholders now own only half of the company because the other half belongs to the new shareholder (who owns 100 shares out of a total of 200 shares). Thus, the voting rights of the old shareholders are diluted from 100% of the rights to vote to only 50% of the voting rights of the company. In addition, the value of the shares owned by the old shareholders decreases to half of the new value of the company and is now worth only $75 (half of $150). However, if the new shareholder pays fair value for the newly-issued shares ($100 for half of the company or $1 per share) then, following this fair transaction, the old shareholders' stake in the company remains $100 (or half of $200) which is the new value of the company after receipt of $100 as consideration for the new shares. The old shareholder now owns only half of the company, but half of a company that is worth twice as much as it was before the stock issuance transaction.

The value of the shares of the old shareholders remains the same, undiluted by the issuance of new shares if the new shares are

31. *See id.*
32. *See id.*
33. *See id.*

issued for their intrinsic fair market value. Yet the voting rights of the old shareholders are diluted even if the consideration the company receives for the new shares is fair, as long as the old shareholders do not participate in the new issue pro rata to their percentage holding prior to the issuance.

An examination of the contours of the managerial power to issue stock aids in understanding the agency cost related to this power. Subpart A describes the rules governing the right to issue shares. Subpart B and Subpart C describe usages of new stock issuances. Subpart D reviews noncontroversial usages of stock issuances, and the latter Subparts discuss usages of the power to issue stock that can be questionable and that affect the control of the corporation.

A. Rules Governing the Issuance of Stock

Generally, the board can issue stock without shareholder approval.[34] This power, however, relies on the availability of sufficiently authorized but unissued shares.[35] A company cannot issue more shares than the number of authorized shares of its capital that are not already issued. Thus, the authorized capital sets the upper limit.

The size of the authorized capital, however, is not controlled by the managers alone. The certificate of incorporation includes the amount of authorized shares of the company.[36] Consequently, the shareholders must approve any changes in the number of authorized shares because the shareholders' approval is needed in order to change the charter of the company.[37]

The number of authorized shares set out in the certificate of incorporation of the company is a statutory upper limit to the total number of shares the managers can issue.[38] Managers can continue to issue shares as long as the total number of issued shares is smaller than the number of authorized shares.[39] The number of shares that the managers can issue without receiving the shareholders' approval equals the difference between the number of authorized shares and the number of shares already issued.[40]

34. DEL. CODE ANN. tit. 8, § 161 (2010).
35. *Id.*
36. *See id.* § 102(a)(4).
37. *See id.* (requiring certificates of incorporation to include the number of authorized shares); *id.* § 242(b)(2) (requiring the approval of the affected class of shareholders for any amendment that changes the number of authorized shares of the class). Maryland is an exception to this rule, for it does not require a shareholder vote to increase the number of authorized shares. *See supra* note 21 and accompanying text.
38. DEL. CODE ANN. tit. 8, § 161 (2010).
39. *See id.*
40. *See* Matteo Arena & Stephen P. Ferris, *When Managers Bypass Shareholder Approval of Board Appointments*, 13 J. CORP. FIN. 4, § 3.1 (2007).

Keeping everything else constant, the higher the number of authorized shares, the higher the number of shares that the mangers can issue. Similarly, everything else equal, the lower the number of existing issued shares, the higher the number of shares that the managers can issue.

However, while the managers cannot unilaterally control the number of authorized shares, they have discretion about whether to issue new shares.[41] Thus, in order to evaluate whether the number of authorized shares effectively restricts managers' power to issue shares, we need to look also at managers' ability to influence the number of already issued and outstanding shares.

Managers can refrain from issuing new shares to keep the number of shares that they can issue high in order to be able to issue more shares in the future. For example, the managers may choose to finance the firm's activities with debt rather than equity.[42] Similarly, managers can opt to pay cash rather than to grant equity-based compensation to employees in order to keep the unissued share reserve intact.[43]

Another way for managers to affect the number of shares they can issue is through share repurchase. In addition to new shares that are not yet issued, managers can use shares that had been issued but were bought back by the company, and thus are no longer outstanding, to sell shares without running afoul of the upper limit set by the authorized capital. When the company repurchases shares, it increases the number of issued-but-not-outstanding shares, which are commonly referred to as treasury shares.[44]

When a company repurchases shares, however, it needs to pay for these shares.[45] Paying for these shares can come at the expense of alternative uses for the company's funds. Conversely, managers who wish to conduct share repurchases may engage in excessive cash retention in anticipation of an opportunity for the share

41. DEL. CODE ANN. tit. 8, § 161 (2010).

42. Absent transaction costs, taxes, and inefficient markets, the choice between debt and equity should not affect the value of the firm. *See generally* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958). However, since companies operate in inefficient markets with transaction costs and taxes, the capital structure of the firm factors into the value of the firm.

43. Cash and equity compensation are not equivalent even when they have equal values. The grant of cash rather than equity has different effects on the company and on the recipient. For one, equity-based compensation is generally believed to align the interests of the employees with those of the company. *See infra* note 64 and accompanying text.

44. It should be noted that quorum and majority requirements are calculated based on the number of outstanding shares and that the company is not allowed to vote or use treasury shares to satisfy the quorum requirement. *See* DEL. CODE ANN. tit. 8, § 160(c) (2010).

45. *See id.* § 160(a).

repurchase.[46] If, however, the company independently plans to make a distribution to the shareholders, the managers may choose to do so by conducting a share repurchase rather than by distributing dividends. By choosing share repurchases, the managers increase the number of shares that may be issued without shareholder approval. There is evidence that suggests that managers opt for share repurchases instead of using dividend distributions.[47]

Indeed, the increase in the pool of shares available for employee stock option grants is one of a few advantages attributed to share repurchases over dividends.[48] The repurchased shares can be used to compensate the employees. Yet doubt has been cast on the need for share repurchases to conduct employee stock option grants that enhance shareholder value.[49] Arguably, the shareholders would approve the requested increase of the number of authorized shares in order to allow such option grants.[50]

However, when the number of unissued authorized shares of the company is just enough for the option grants, the managers may be reluctant to use the surplus of authorized-but-unissued shares for the option grants. Such grants may not leave a sufficient number of authorized-but-unissued shares that may be needed for other purposes that enhance the personal interests of the managers, such as entrenchment. Unlike shareholder-serving employee option grants, certain manager-serving transactions are unlikely to receive the support of the shareholders and may not obtain the shareholder approval needed to increase the number of authorized shares. Similarly, where the number of unissued authorized shares is just enough for the option grants, the shareholders may not agree to increase the authorized capital at the time of the option grants, knowing that it is not needed for the option grant but that the

46. For an analysis of potential costs and benefits of share repurchases on managerial cash-hoarding practice, see Jesse M. Fried, *Informed Trading and False Signaling with Open Market Repurchases*, 93 CAL. L. REV. 1323, 1371 (2005) ("To the extent that the prospect of future bargain repurchase opportunities lead [sic] to cash hoarding, managers' ability to engage in such repurchases does not mitigate the problem of free cash retention.").

47. *See, e.g.*, *id.* at 1326 ("[T]he use of share repurchases to distribute cash has since grown substantially in the United States, increasing from $6.6 billion in 1980 to almost $200 billion in 2000."); Douglas J. Skinner, *The Evolving Relation Between Earnings, Dividends, and Stock Repurchases*, 87 J. FIN. ECON. 582, 585 (2008) (stating that newer firms with no history of paying dividends (like Cisco and Dell) tend to rely exclusively on stock repurchases and are unlikely to initiate dividends, helping to explain the declining propensity to pay dividends; since 1980, these firms display an increasing tendency to use repurchases rather than dividends; repurchases now represent about half of total payouts).

48. *See* Fried, *supra* note 46, at 1327–28.

49. *Id.*

50. *Id.*

increase will allow the managers to issue shares in the future for different purposes without going back to the shareholders for approval.

Thus, the limit on the amount of shares that managers can issue without the approval of the shareholders influences the managers' choice between share repurchase and dividends and adds an additional motivation in favor of share repurchases. Yet, in spite of certain benefits attributed to share repurchases, there is evidence that suggests dividends are, at least in some cases, significantly more efficient than share repurchases and involve lower transaction costs.[51]

In addition to the quantitative limitation on the managerial power to issue stock, issuances of stock are subject to consideration requirements. The Delaware requirements, however, are very lenient and allow for the issuance of shares in exchange for any benefit to the corporation.[52] Moreover, the Delaware statute gives full deference to the directors' judgment regarding the value of the consideration absent actual fraud.[53]

Another important mechanism that can reduce the number of shares that are issued and outstanding is a reverse stock split. In a reverse stock split the company replaces the outstanding shares of all the shareholders with a lower number of new shares. For example, in a reverse stock split, with a ratio of 1:10, every ten shares are replaced with only one new share. Since a reverse stock split decreases the number of outstanding shares, it can increase the number of authorized but not outstanding shares of the company. However, as with the case of changing the number of authorized shares, in Delaware a reverse stock split requires shareholder approval.[54] Thus, the managers cannot unilaterally use a reverse

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51. *Id.* at 1327–29.

52. DEL. CODE ANN. tit. 8, § 152 (2010) ("The board of directors may authorize capital stock to be issued for consideration consisting of cash, any tangible or intangible property or any benefit to the corporation, or any combination thereof.").

53. *Id.* ("In the absence of actual fraud in the transaction, the judgment of the directors as to the value of such consideration shall be conclusive."). Similar rules govern the issuance of options to purchase shares. *Id.* § 157; *see also* Zupnick v. Goizueta, 698 A.2d 384, 387 (Del. Ch. 1997) ("[S]o long as there is any consideration for the issuance of shares or options, the sufficiency of the consideration fixed by the directors cannot be challenged in the absence of actual fraud. Only where it is claimed that the issuance of shares or options was entirely without consideration will § 157 not operate as 'a legal barrier to any claim for relief as to an illegal gift or waste of corporate assets in the issuance of stock options.'" (quoting Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979))).

54. Blades v. Wisehart, No. 5317-VCS, 2010 Del. Ch. LEXIS 227, at *28–29 (Del Ch. Nov. 17, 2010) ("[I]n order to effect a forward or reverse stock split, the corporation must follow the prescribed corporate formalities to amend its certificate of incorporation in such a manner that 'splits' the outstanding shares

stock split to increase their power to issue stock.

B. Conventional Business-Operation-Related Reasons to Issue Shares

When the company needs funds for its operations it can generally consider financing either through equity or through debt.[55] Limited access to equity or debt can dictate the capital structure of the corporation and thus leave no alternative for the managers but to elect the only available option. For example, in the early stages of the corporation, high-tech startups usually do not have any tangible assets that can serve as collateral for a loan.[56] Consequently, the ability of a startup founder to raise money for her risky enterprise through debt is practically nonexistent.[57] In such corporations, financing is limited to equity financing and issuances of stock are crucial for the corporation's continued operations.

To the extent that both equity and debt financing are available to the corporation, the management chooses the level of each of the financing sources and sets the capital structure of the corporation. The managerial choice between these two sources of financing and its effect on the corporation have been studied by finance scholars.[58] These studies show that the value of the corporation is sensitive to changes in the capital structure of the corporation, given real world assumptions of taxes, transaction costs, and inefficient markets.[59] Thus, even when debt financing is available, it may be more efficient for the corporation to use equity to raise capital for its operations. For example, debt may be available only if the corporation undertakes to agree to certain restrictive covenants that are

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in accordance with the corporation's intentions."). *Cf.* Jesse M. Fried, *Firms Gone Dark*, 76 U. CHI. L. REV. 135, 142 (2009) ("Some state corporate laws may permit a reverse stock split without shareholder approval in certain circumstances."); MINN. STAT. ANN. § 302A.137(a) (West 2010).

55. *See Definitions*, US LEGAL, http://definitions.uslegal.com/d/debt-financing (last visited Sept. 15, 2011).

56. *See* Massimo G. Colombo & Luca Grilli, *Funding Gaps? Access to Bank Loans By High-Tech Start-Ups*, 29 SMALL BUS. ECON. 25, 28 (2006).

57. To be sure, there may be exceptions to this limitation on raising debt. For example, a very reputable entrepreneur who founds a new startup after prior proven success may not face much difficulty raising any type of financing for the new start-up, including debt. Financial institutions may choose to assume the risk and waive the collateral requirement, but they are likely to ask for individual guaranties in most situations.

58. *See supra* note 42 and accompanying text.

59. The Modigliani-Miller theorem shows that the method of finance chosen does not affect the value of the firm as long as the markets are efficient and there are no transaction costs and no taxes. However, once taxes, transaction costs, and inefficient markets are introduced, the capital structure of the corporation can have a notable effect on the value of the firm. *See* Modigliani & Miller, *supra* note 42.

designed to protect the lenders.[60] Since the lenders do not share in the upside of the corporation, these covenants may be overly restrictive.[61] Thus, the corporation's ability to issue stock can be central for operations because the stock issuance enables the corporation to receive needed funds.

Grants of shares are also commonly used in another ordinary business-enhancing practice aimed at creating a common interest between the recipients of the new shares and the company.[62] Equity-based compensation is the main example for this use of shares.[63] When an employee receives equity in the company, she receives an incentive to increase the value of the company.[64] Issuing shares is useful when the company is interested in motivating a person to increase the value of the company's shares. If the person participates in the upside of the company and is negatively affected when the company is doing poorly, it increases her interest in the success of the company. To be sure, equity-based compensation can be vulnerable to managerial manipulation that weakens the incentive effect of the equity.[65] However, commentators have shown

60. *See, e.g.*, Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 13 (2008) ("Debt covenants typically . . . oblig[e] executives to operate the company within tight budgetary and operational constraints.").

61. *See* Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty Upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813, 1823 (2002) ("[M]anagers required to maximize creditor value when the firm is insolvent might forgo risky opportunities that increase total value because they make creditors worse off. This problem, of course, is the inevitable result of an approach that seeks to maximize creditor value without regard to the effect on shareholder value. . . . The intuition behind this . . . is that creditors bear most of the downside if the firm does poorly but do not enjoy much of the upside if the firm does very well.").

62. *See* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups,* 81 N.Y.U. L. REV. 967, 976 (2006).

63. *See id.* at 1010.

64. *See, e.g.*, *id.* ("[E]quity compensation aligns the interests of employees with those of shareholders."). Equity compensation can also be used as a substitute for cash compensation when the company cannot compete for talent on the basis of salaries, as is frequently the case with startups. *See id.* ("Equity compensation allows liquidity-constrained firms, which are unable to pay competitive salaries and cash bonuses, to compete in the labor market for talented employees."); *see also* Ganor, *Why Do Managers Dismantle Staggered Boards?*, *supra* note 10, at 162 (studying the connection between CEO equity holdings and the decision to de-stagger the board, based on the hypothesis that "[t]he CEO's equity holdings help to create an interest in the increase of the company's value, or at least in the stock price (the perceived market value of the company)").

65. *See, e.g.*, Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 763, 783–86 (2002) (criticizing prevailing equity compensation practices for providing suboptimal incentives); Hu & Black, *supra* note 29, at 831–32 (analyzing managers' custom of hedging their personal exposure by purchasing financial instruments such as zero-cost collar); Eli Ofek & David Yermack,

that properly designed limitations, such as vesting schemes, unwinding limitations, and hedging restrictions, can ensure a closer connection between the equity compensation and long-term performance.[66]

However, neither raising money nor compensating employees has to be equity based. Instead, the company can often use debt financing to support its operations and use cash to pay its employees. Furthermore, when the company has liquidity constraints, the managers do not have to use equity even when they have no alternative to equity financing. Rather, they can choose to scale down the business. Reluctant to issue a considerable amount of new equity, the managers can revert to downsizing the operations of the company while forgoing growth opportunities and profitable projects.[67] Similarly, paying cash to compensate employees through salaries and monetary bonuses and reducing the workforce are alternatives to the use of employee equity compensation.

C. Control Related Uses of the Power to Issue Shares

The previous Subpart showed that managers can use the power to issue stock for basic business operations of the company. This Subpart looks at more special uses of the power to issue stock that do not involve the daily operations of the company but rather relate to the ability of the mangers to control fundamental changes to the corporation.

1. The Poison Pill

The poison pill, a shareholders' rights plan, is an effective antitakeover mechanism that enables the managers to block and deter hostile takeovers.[68] The poison pill dilutes both the value of

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Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership, 55 J. FIN. 1367, 1367–68 (2000) (reporting that managers can hedge the risk of equity-based compensation, yet companies justify the use of equity incentive compensation by arguing that it helps reduce agency problems).

66. *See, e.g.*, Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1919–20 (2010) (suggesting limitations on equity-based compensation that will optimally tie managerial pay to long-term performance).

67. To be sure, while scaling down the core operations of the company, managers may prefer to use scarce resources on empire building which includes sizable acquisitions of other businesses for the purpose of increasing the managers' power and increasing the size of the company. This makes it more difficult to take over the company and helps to entrench the managers.

68. Guhan Subramanian, *Bargaining in the Shadow of PeopleSoft's (Defective) Poison Pill*, 12 HARV. NEGOT. L. REV. 41, 42–43 (2007) ("It is widely believed that a poison pill, even a plain vanilla pill, is a 'show-stopper' against a hostile bidder because it severely dilutes an acquirer's stake if triggered."); *see also* Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 HOFSTRA L. REV. 835, 837 (1998) ("Target firms can now keep their poison pills in place and 'just say no' to would-be acquirers, regardless of the

the raider's shares and the voting power of the shares.[69] The poison pill creates a credible threat to distribute new shares to all the shareholders except to the raider for a radically low price.[70] The target managers' ability to credibly threaten the issuance of a large number of significantly undervalued stocks makes a hostile takeover economically prohibitive.

A simple example may illustrate the mechanics of the poison pill. Suppose the company has 100 million shares issued and outstanding. The shares are publicly traded at $10 per share. Suppose further that the management has put in place a poison pill that is triggered when a hostile acquirer accumulates 10% of the equity of the company. Assuming that under the terms of the poison pill, once it is triggered, all the shareholders except for the hostile acquirer obtain the right to purchase one share for each share they own for half the price—then they will pay only $5 per share.

A hostile acquirer buys 10% of the shares of the company, 10 million shares, for $10 per share, for a total investment of $100 million. This acquisition triggers the poison pill and the management distributes to all the shareholders, except for the hostile acquirer, new shares at a rate of one new share for each existing share. The company distributes a total of 90 million new shares. After the distribution, the company has 190 million shares issued and outstanding, of which the hostile acquirer owns 10 million shares.

In this example, the hostile acquirer's stake decreased from 10% of the company to only 5.26% of the company.[71] In addition, after the distribution of the new shares following the triggering of the poison pill, the company's total value is $1450 million, the sum of the original $1 billion plus the consideration received for the new shares of $5 per each of the 90 million new shares or a total of $450 million. As a result, the value of the hostile acquirer's investment is now worth only $76.3 million,[72] almost a quarter less than the original investment.

The above example demonstrates that triggering a poison pill is very expensive to a hostile bidder. The example also demonstrates that the mechanism of the poison pill relies on the managers' ability to issue shares upon the triggering event. In fact, in order to have a strong dilutive effect on the hostile bidder, the management needs to issue a very significant number of shares relative to the already issued shares. In the above example, the company only issued one share for every share already issued, or a 1:1 ratio. In a seminal study of poison pills, Guhan Subramanian reports that in the

market premiums these acquirers are willing to pay to shareholders.").

69. *See* Macey, *supra* note 68, at 839.

70. *See id.*

71. 10 million ÷ 190 million = 5.26%

72. 5.26% × $1,450 million = $76.3 million

sample of large publicly traded software companies the average poison pill provided for thirteen shares of the target for each existing share, or a ratio of 13:1.[73] These considerably larger ratios require a nontrivial, large number of authorized-but-unissued shares to enable the exercise of the rights under the poison pill.[74]

The desirability of the poison pill has been extensively debated.[75] Supporters of the poison pill approve of the managers' ability to prevent, or at least delay, a hostile acquisition of the corporation, arguing that a managerial veto may help enhance shareholder welfare.[76] Holders of the opposite view, however, voice strong concerns about the significant agency costs that a poison pill creates.[77] Managers may use a poison pill to block an efficient acquisition in order to entrench themselves.[78] The managers may also use the poison pill to negotiate for personal benefits from the acquirer.[79] A body of empirical studies supports the opponents of the poison pill and shows that the poison pill results in a significant negative effect on shareholder wealth.[80]

2. *The Top-Up Option*

Another nontrivial use of the managers' power to issue stock, the top-up option, also arises in the context of a change in control following an acquisition of the company. Like the poison pill, a top-up option is granted to ensure the outcome the managers want to promote, regardless of the shareholders' vote.[81] Unlike a poison pill, a top-up option is used when the management prefers the acquisition;[82] the top-up option is designed to force through an

73. *See* Subramanian, *supra* note 68, at 44 (studying the poison pills of "U.S. publicly-traded software companies with market capitalization of at least $1 billion").

74. PeopleSoft, for example, could not have exercised the rights under its poison pill unless it used a cashless exercise because the company did not have a sufficient number of shares of authorized common stock, even though PeopleSoft had almost twice as many authorized shares as issued shares. *See* Subramanian, *supra* note 68, at 49 n.11.

75. For a review of the debate about the efficacy of the poison pill, see generally Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002).

76. *See id.* at 988–90.

77. *See id.* at 991–94.

78. *Id.* at 991 ("[M]anagers might elect to block a beneficial acquisition in order to retain their independence.").

79. *Id.* ("[M]anagers might use their power to extract not a higher premium for their shareholders but rather personal benefits for themselves.").

80. For a review of the empirical studies, see *id.* at 992–93.

81. *See* Aaron Dixon, *Delaware Chancery Court Provides Guidance for Terms of Top-Up Options* (Mar. 7, 2011), http://www.alston.com /mergersandacquisitionsblog/blog.aspx?entry=4255.

82. Davis Polk & Wardwell LLP, *Top-Up Options – Looking Better and Better* (Oct. 8, 2010), http://www.davispolk.com/files/Publication/eeadddb8-7d4a -4a94-b4ad-0ec5c2f1e32d/Presentation/PublicationAttachment/2f8068f4-8c6b-47

acquisition and a subsequent shareholder freeze-out despite the opposition from a large block of the minority shareholders.[83] Like the poison pill, as demonstrated in this Part, the top-up option is likely to involve agency costs and diminish shareholder wealth.[84]

A top-up option is a choice that the board of a company gives to a bidder who wants to acquire the company.[85] After receipt of the option, the bidder conducts a tender offer.[86] If the tender offer is successful and the bidder acquires at least a majority of the shares,[87] then the top-up option allows the bidder to proceed with the takeover of the company and buy directly from the company newly-issued shares that, together with the shares tendered in the tender offer, will represent 90% of the issued and outstanding shares of the company. Owning 90% of the capital of the company allows the bidder to buy out the nontendering shareholders using a freeze-out short-form merger.[88] A short-form merger does not require a meeting or a vote of the shareholders and leaves the shareholders with only appraisal rights as their sole recourse.[89] In Delaware, a short-form merger only requires owning 90% of each class of shares of the company.[90]

a. Mechanism

The following example illustrates the mechanics of the top-up option and the resulting implications to the company's capitalization. Suppose there are 100 shares issued and outstanding before the tender offer. Assume the bidder received 50 shares in the tender offer, which also represent 50% of the total issued and outstanding shares of the company. Following the exercise of a top-up option the company will issue new shares to the bidder, who will own 90% of the number of all outstanding shares at that time. How many shares should the company issue to the bidder? In this example the company has to issue 400 new shares to the bidder, increasing the total number of issued and outstanding shares from 100 to 500 shares. After the exercise of the option the bidder will own 450 shares, comprised of 50 shares that she purchased in the tender offer from the shareholders and another 400

23-8d2e-14008cae67ef/100810_topup_options.html.

83. *See* Dixon, *supra* note 81.

84. *See supra* note 82 and accompanying text.

85. *See id.*

86. *See* Dixon, *supra* note 81.

87. The minimum percentage of shares needed to be acquired at the tender offer to allow for the subsequent exercise of the top-up option is usually set at 50%. *See supra* note 82 and accompanying text.

88. DEL. CODE ANN. tit. 8, § 253(a) (2010).

89. *See* Glassman v. Unocal Exploration Corp., 777 A.2d 242, 248 (Del. 2001) ("[A]ppraisal is the exclusive remedy available to a minority stockholder who objects to a short-form merger.").

90. DEL. CODE ANN. tit. 8, § 253(a) (2010).

shares that the company issued directly to the bidder following the exercise of the top-up option. The 450 shares held by the bidder after the exercise of the top-up option make up 90% of the new total number of shares, which includes 500 shares. The following table summarizes the capitalization of the company.

TABLE 1: COMPANY CAPITALIZATION

	Bidder's Shares	Non-tendering Shareholders	Total Number of Shares	Bidder's Percentage
Tender Offer	50	50	100	50%
Top-Up Option	400	0	400	100%
Total	450	50	500	90%

More generally, to reach 90% of the shares, the company needs to issue the bidder *ten* times the difference between the percentage she has acquired and the desired 90%. In the previous example, the difference was 40%—the bidder acquired 50% in the tender offer and thus was 40% short of 90%. Ten times the difference of 40% is 400%. The formula that can be used to derive the number of shares that the company needs to issue if a top-up option is exercised can thus be illustrated algebraically as:

$$X = (90\% - Y) \times 10$$

X represents how many shares the company shall issue to the bidder in exchange for the exercise of the top-up option as a percentage of the outstanding shares immediately before the exercise of the option, or 400% in our example. Y represents the percentage of outstanding stock the bidder owns following the tender offer, or 50% in our example.[91] Thus, as the formula demonstrates, a large number of shares is needed to use a top-up option.

Once the bidder exercises the top-up option, she needs to buy the new shares from the company and pay the same price for these shares that she paid in the tender offer. A lower price will not represent a fair market price and may be easily challenged since the tender offer price establishes a fair market price for the shares. As the example above illustrates, a large number of shares is issued when the top-up option is exercised; hence, the consideration that the bidder should pay the company for these shares is substantial. However, the consideration for the shares can be, and often is, paid

91. $(Y+X) \times (\text{shares outstanding}) / (100\%+X) \times (\text{shares outstanding}) = 90\%$

with an unsecured note except for a small part, which represents the par value of the shares.[92] Following the short-form merger, the unsecured note issued in exchange for the shares is nullified because after this merger the holder of the note is combined with the issuer of the note and they become one.[93]

Therefore, the top-up option, like the poison pill, requires a significant number of authorized-but-unissued shares to allow for the management to issue shares as part of this scheme.

b. Agency Costs

The power to issue stock to grant a top-up option to a potential bidder can be abused by self-interested managers and hurt the shareholders' wealth. The performance of a short-form merger after the tender offer not only allows for a speedy merger because there is no need for a shareholder meeting, a proxy statement, or a shareholder vote, but it also restricts the remedies available to the dissenting shareholders.[94] Statutorily, the short-form merger is restricted to a situation in which the acquirer owns more than a simple majority of the shares. In Delaware, the requirement is at least 90% of the company's issued shares.[95] The short-form merger protects against holdups by a very small number of shareholders who together own up to 10% of the company's stock. The top-up option artificially transforms the acquirer into a holder of 90% of the shares, while the dissenting shareholders constituted more than the maximum statutory threshold of 10% before the exercise of the option.[96]

A dissenting shareholder's only remedy in a short-form merger

92. DEL. CODE ANN. tit. 8, § 153(a) (2010) ("[S]hares of stock with par value may be issued for . . . not less than the par value.").

93. *See, e.g.*, *In re* Appraisal of Metromedia Int'l Grp., Inc., 971 A.2d 893, 898–99 (Del. Ch. 2009) ("As part of the Top-Up Option, MergerSub paid MIG $2 million in cash and issued an unsecured promissory note to MIG in the amount of $358 million in exchange for the additional 200 million common shares. . . . MergerSub merged into MIG, with MIG as the surviving entity. . . . The promissory note given by MergerSub was cancelled because the obligor (MergerSub) and the obligee (MIG) on the promissory note became the same entity, making the note a nullity.").

94. In *Glassman v. Unocal Exploration Corp.*, the court held that a minority stockholder's only recourse in challenging a short-form merger under 8 Del. Code § 253 was appraisal, stating that "we have held that claims for unfair dealing cannot be litigated in an appraisal. . . . stockholders may not receive recissionary relief in an appraisal." 777 A.2d 242, 248 (Del. 2001) (reaffirming the interpretation of the appraisal statute's scope set forth in *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983)).

95. DEL. CODE ANN. tit. 8, § 267 (2010).

96. If the acquirer was able to receive at least 90% of the shares in the tender offer on her own, then there would have been no need for her to receive a top-up option.

is appraisal and not entire fairness.[97] Thus, the use of the top-up option also protects the board that serves after the tender—the board does not need to perform a statutory long-form merger, which could have subjected the directors to a fairness review.[98] In this manner the bidder can go ahead with the acquisition even in the face of sizable shareholder opposition.

To be sure, in exchange for the grant of the top-up option the managers may have succeeded in negotiating better terms for the selling shareholders—a higher purchase price. However, the managers' interest in the acquisition may be influenced by personal interests. The managers may be connected to the acquirer through a business association or other relationship with the acquirer. The acquirer herself may have been a member of the board, and as a result, the acquirer and other managers may have developed close ties because they served together on the board for a long time as colleagues.

The managers may also stand to gain from the acquisition directly. For example, a promise from the acquirer to grant the target's directors perpetual thrones (i.e., nominations to the board of directors of the acquirer, may personally incentivize the managers to favor the acquisition).[99] The managers may have used their negotiation powers to extract benefits for themselves, which may include lucrative retention plans and retention bonuses as well as perpetual thrones. In exchange for arrangements that benefit the managers, however, the shareholders may well have been deprived of the ability to extract a higher price from the acquirer.

The party interested in acquiring the company and freezing out all of the shareholders has a choice. For one, the acquirer can ask the managers for a top-up option and reward them for their support. Under this option, it is sufficient for the acquirer to receive only 50% of the shares in the tender offer and use the top-up option to own 90% of the shares. Alternatively, the acquirer can conduct a tender offer without the support of the managers and without a top-up option, with the intent of receiving 90% of the shares immediately in the tender offer itself.

Convincing 50% of the shareholders to sell is not the same as convincing 90% of the shareholders. A bidder must offer all the shareholders the same price per share.[100] Since the acquirer faces

97. *Glassman*, 777 A.2d at 248.

98. *See, e.g.*, Bomarko, Inc. v. Int'l Telecharge, Inc., 794 A.2d 1161, 1177 (Del. Ch. 1999) (explaining that in addition to the appraisal remedy, other forms of equitable relief are available if the court finds that a long-form merger was not entirely fair).

99. *See generally* Ganor, *Salvaged Directors or Perpetual Thrones?*, *supra* note 10.

100. *See* 17 C.F.R. § 240.14d-10(a)(2) (2011) ("The consideration paid to any security holder for securities tendered in the tender offer is the highest consideration paid to any other security holder for securities tendered in the

diverse shareholders, rather than only one seller, she likely faces an upward-sloping supply curve,[101] meaning that more shareholders are willing to sell their shares at a higher price than for a lower price. The higher the offer price used in the tender offer, the higher the number of shareholders willing to tender their shares at the tender offer. The result is that if the bidder needs to receive more shares in the tender offer, she also has to increase the price offered.

The top-up option, however, essentially truncates the supply curve that the bidder in the tender offer faces and allows her to offer a lower price—the price that will clear only 50% of the shares rather than the higher 90%. The remaining shareholders who did not want to sell for the low tender offer price will receive the same price paid in the tender offer in the freeze out short-form merger that will follow the exercise of the top-up option.[102] Thus, it seems that the receipt of the top-up option allows the acquirer to buy the company for a lower price, which hurts the wealth of the shareholders.

The following example illustrates the effect of the top-up option on the price of the tender offer. Suppose the company has four shareholders each owning 25% of the equity of the company. Shareholder A values the company's shares at $10 per share; shareholder B thinks the shares are worth $11; shareholder C assumes that the right price is $12; and shareholder D, being very optimistic about the future of the company, estimates the price of the share at $13. The table below lists the values that each of the four shareholders assign to the company's shares. The holders of 50% of the shares will agree to sell the company for a price of $11 per share; however, the holders of 90% of the shares will not agree to sell the company for $11 per share. If the holders of 90% of the shares must consent to the sale, the shareholders should be offered at least $13 per share.

tender offer.").

101. *Cf.* Mira Ganor, *Manipulative Behavior in Auction IPOs*, 6 DEPAUL BUS. & COM. L.J. 1 (2007) (demonstrating a strategic use of the downward sloping of the demand for shares).

102. In a typical top-up option agreement, the bidder undertakes to pay at the back-end squeeze-out the same price that he pays at the tender offer. *See, e.g.*, Olson v. ev3, Inc., No. 5583-VCL, 2011 Del. Ch. LEXIS 34, at *2 (Del. Ch. Feb. 21, 2011). Without this undertaking the tender offer may be perceived as structurally coercive and could face judicial scrutiny. *Cf. In re* Pure Res., Inc. S'holders Litig., 808 A.2d 421, 445 (Del. Ch. 2002). The nontendering shareholders who oppose the subsequent short-form merger can, of course, use their appraisal right and receive the court-assigned fair market price of the shares. The tendering shareholders will not have their price adjusted even if the tender price is lower.

TABLE 2: SHAREHOLDERS' VALUE OF COMPANY'S SHARES

Shareholder	Price per Share	Accumulated Percentage
A	$10	25%
B	$11	50%
C	$12	75%
D	$13	100%

On occasion, the holder of the median share may agree to sell for a fair price; however, many times shareholders waiting for an opportunity to dump their shares form the bottom of the supply curve. They will sell even at a lower price than the shares are worth, since they cannot do so in the open market because their sale of the shares would cause the price to drastically go down, causing them further loss. A sale of a significant stake may negatively affect the market price. The identity of the seller may also negatively affect the price where, for example, the seller is a sophisticated investor or is in a business relationship with the company and the market is likely to view such a sale as a negative sign.[103] Thus, the price the holder of the median share is willing to accept may not represent a fair price.

It may be efficient to let the deal through at a lower price so that the shareholders waiting to liquidate their holdings may do so even at the expense of the other shareholders who would like to receive a more equitable value for their shares. However, it may also be the case that it is not just a zero-sum game in which the acquirer wins because she pays less in a transfer of wealth from the shareholders to the bidder. It may well be that the transaction is inefficient because the acquirer is going to run the operations of the company less efficiently than the company was run as a standalone operation before the acquisition. In this case, the acquirer truly values the company less than the nontendering shareholders.

The appraisal rights of the dissenting shareholders are designed to ensure that these shareholders receive a fair value for their shares.[104] Nevertheless, it is well known that the judicial appraisal remedy offers but a weak defense.[105] Calculating the fair value of a

103. *See, e.g.*, Gholl v. eMachines, Inc., No. 19444-NC, 2004 Del. Ch. LEXIS 171, at *64–65 (Del. Ch. Nov. 24, 2004) ("Both TriGem and AOL . . . were *past* strategic partners of eMachines. TriGem was being pressured by its biggest customer, and eMachines competitor, Hewlett Packard to distance itself from eMachines. AOL had been a partner of eMachines under its old Internet-revenue business model, but was by late 2001, not a part of eMachines' future plans. These facts suggest that these stockholders may well have had a number of reasons for approving the Merger and thereby creating a liquidity event for themselves, other than a careful and reliable valuation analysis.").

104. *See* Fried & Ganor, *supra* note 62, at 1003.

105. *See, e.g.*, *id.* at 1004–05 ("Unfortunately, the appraisal remedy is an

share is not an easy task. It is based on several assumptions that are hard to predict, such as the appropriate future interest rates and future exchange rates, and it involves forecasting methodologies that are far from being an accurate science. Efficient markets help reveal the fair market value of shares.[106] Yet, markets are rarely perfectly efficient, and indeed, acquirers do not pay the shareholders the price at which the shares are traded in the markets. This affects the predictability of the outcome of the appraisal process and thus increases the risk of a small individual shareholder.

Furthermore, the appraisal litigation procedure involves strict requirements of notification deadlines and a short period for filing.[107] On the other hand, the appraisal procedure itself may take years, is expensive, complex, and involves the risk of the acquirer becoming insolvent by the time of the resolution of the litigation.[108] Thus, given the complexity and costs associated with the appraisal procedure, shareholders who oppose the short-form merger may be better off accepting the offered consideration and may choose not to use their right to a judicial appraisal even where they believe they are not fairly compensated for their shares.

The case of *Gholl v. eMachines* is an example of a successful appraisal action that included a top-up option.[109] eMachines, a seller of personal computers and Internet services, went public in March 2000 at a price of $9 per share.[110] By the end of 2000, eMachines was doing poorly and its stock was trading at only $0.5 per share.[111] In 2001, in an effort to reform the business, the company hired a new management team, replacing its top ranking

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extremely weak constraint . . . [and c]ommentators have long recognized that appraisal is a remedy that few shareholders will seek under any circumstance.").

106. *See* Peter V. Letsou, *The Role of Appraisal in Corporate Law*, 39 B.C. L. REV. 1121, 1145 (1998).

107. *See id.* at 1156–60 (describing and analyzing procedural rules of appraisal remedy); Fried & Ganor, *supra* note 62, at 1003–05.

108. *See, e.g.*, Fried & Ganor, *supra* note 62, at 1003–05; Richard T. Hossfeld, *Short-Form Mergers After* Glassman v. Unocal Exploration Corp.*: Time to Reform Appraisal*, 53 DUKE L.J. 1337, 1353 (2004) (noting that shareholders seeking appraisal "must also hold an illiquid claim for almost two years, forgoing investment in other promising opportunities that may arise in the interim"); Alexander Khutorsky, *Coming in From the Cold: Reforming Shareholders' Appraisal Rights in Freeze-Out Transactions*, 1997 COLUM. BUS. L. REV. 133, 160 (recommending setting "statutory rate of interest at the 'borrower's' cost of debt" to fairly compensate dissenting shareholders, where "borrower" is majority shareholder); Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 40 (1995) (describing the complicated requirements of appraisal and the unavailability of a class action suit).

109. *See* Gholl v. eMachines, Inc., No. 19444-NC, 2004 Del. Ch. LEXIS 171, at *72 (Del. Ch. Nov. 24, 2004).

110. *Id.* at *4.

111. *Id.* at *5.

officials (both its CEO and COO) who introduced a new business plan.[112]

By mid-2001 the company's business had completely turned around, despite the market perception to the contrary.[113] The board considered its alternatives, including selling the company, and for that purpose started a bidding process.[114] However, the only potential acquirer who offered to buy the company offered to pay less for it than the value of the company's cash; thus, the company rejected the offer and ended the bidding process in mid-September.[115]

In October, one of the founders of the company, and a member of its board, submitted a low offer to purchase the company for less than the last offer made by the outside bidder less than three months before.[116] The board contacted the outside bidder, and a bidding war ensued between the director and the outside bidder in mid-November.[117] On November 16, the board announced that all final bids should be submitted within two days.[118] The director won the bid, offering $4.2 million less than the company's cash value and ignoring the value of the company's operations.[119] The price was set at $1.06 per share.[120] Nonetheless, the company received a fairness opinion from a financial advisor that indicated the director's offer was fair, based on valuation studies the advisor conducted.[121]

The board approved the merger, granted the bidding director a top-up option, and recommended the deal to the shareholders.[122] The bidding director conducted a successful tender offer that did, however, leave him short of the 90% of the shares needed for a short-form merger.[123] He then exercised his top-up option, acquired the shares he needed to reach 90% of the equity of the company, and performed a short-form merger—freezing out the minority nontendering shareholders by the end of the year.[124]

In the appraisal case brought by nontendering shareholders, the court did not rely on the auction price because it doubted the fairness of the auction and the effectiveness of the manner in which

112. *Id.*
113. *Id.* at *7.
114. *Id.* at *9.
115. *Id.*
116. *Id.* at *10.
117. *Id.*
118. *Id.* *10–11.
119. The bidding director's offer represented a company value of $161 million, and the company had $165.2 million in cash. *See id.* at *11, *69.
120. *Id.* at *11.
121. *Id.*
122. *Id.* at *14.
123. *Id.*
124. *Id.*

the auction was conducted.[125] The court assumed that while "as a co-founder, insider, and director, [the bidding director] had access to internal projections and other inside information . . . it is unclear how the information regarding eMachines' improving fortunes that was made available to [the outside bidders] compares to that available to [the inside director]."[126] The court also noted that "[t]he quick termination of the bidding may have kept the price down and reduced the chances of another bidder entering the auction."[127] Thus, considering all factors available to it, the court came up with its own valuation of the company, a fair value of $1.64 per share.[128]

The difference between the tender-offer price of $1.06 and the price the court awarded, $1.64, an increase of about 55%, helps illustrate the potentially substantial agency costs that may be involved in a top-up option. However, even though the bidding director lost the appraisal case and was ordered to pay 55% more than the offer price, he was forced to pay the higher price only to the former shareholders who exercised their appraisal right.[129] Since only a small number of shareholders had exercised their appraisal rights, a mere 1,344,600 shares in total,[130] the bidding director had to pay less than $0.8 million extra,[131] which pales in comparison to his gain from the acquisition even when one only takes into account the company's cash.[132]

In this case, the manager likely had inside information about the promising prospects of the company and thus may have benefited from the use of a top-up option that expedited the procedure, which was finalized before news about the positive change in the company's forecast became public knowledge. Not surprisingly, the other managers of the company supported their colleague, recommended the deal to the shareholders, and also granted a top-up option that facilitated the speedy completion of the acquisition.[133]

The appraisal route is the only remedy available to the dissenting shareholders after the short-form merger.[134] It is possible, however, to try to challenge the actual grant of the top-up option by the board upon the announcement of the tri-step merger, which starts with the tender offer, proceeds with the exercise of the top-up option, and concludes with the short-form merger. The grant

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125. *Id.* at *60–61.
126. *Id.* at *63.
127. *Id.*
128. *Id.* at *69.
129. *Id.* at *73.
130. (339,000 + 1,005,600) = 1,344,600 shares, representing less than one percent of the total of 154,612,560 outstanding shares. *See id.* at *2, *69.
131. 1,344,600 × $0.58 = $779,868.
132. *See supra* note 119 and accompanying text.
133. *See eMachines*, 2004 Del. Ch. LEXIS 171, at *14.
134. *See* Hossfeld, *supra* note 108, at 1337.

of the top-up option is announced together with the imminent tender offer as part of one agreement between the bidder and the company.[135] Challenging this agreement is not easy, and the main and clear beneficiary of such challenges seems to be the plaintiffs' bar. The following cases provide two examples of class actions that questioned the grant of a top-up option as part of a request for injunctive relief to prevent a tender offer from proceeding. These proceedings help illustrate both the difficulty of challenging the grant of a top-up option under the current system and the potential agency costs associated with the top-up option.

In the case of the sale of ZymoGenetics, Inc. to Bristol-Myers Squibb Company, the plaintiffs asked the court for injunctive relief to stop the sale of ZymoGenetics.[136] ZymoGenetics, a growing pharmaceutical company, was developing a few drugs that had a substantial market and a significant potential for success.[137] The plaintiffs alleged that the directors of ZymoGenetics breached their fiduciary duties to the company's shareholders by supporting the sale of the company for an allegedly unfair and low price in a process that included "unreasonable" devices.[138] The complaint listed the top-up option as one of these devices and argued that its intent was to "circumvent the requirement of a shareholder vote."[139] The plaintiffs further alleged that the directors only agreed to the sale in order to further their own personal benefit.[140] The complaint asserted that a few of the company's directors had traded the interests of the shareholders for "hundreds of thousands of dollars in personal benefits."[141]

Shortly after the filing of the complaint, the parties reached a settlement agreement. The company and its directors continued to deny the plaintiffs' claims; however, as part of the settlement the company agreed to provide the public shareholders additional information concerning the acquisition, including disclosing information of the transaction bonus that the CEO, who also served as a director, would receive upon the closing of the sale.[142] The

135. *See eMachines*, 2004 Del. Ch. LEXIS 171, at *14.

136. *See* Amended Class Action Complaint at ¶ 46, Mesa v. ZymoGenetics, Inc., No. 2:10-cv-01486 (W. D. Wash. Sept. 17, 2010), *available at* http://sec.gov/Archives/edgar/data/14272/000119312510219518/dex99a11.htm.

137. *See id.*

138. *See* ZymoGenetics, Inc., Recommendation Statement (Schedule 14D-9), at Item 8 (Sept. 15, 2010), *available at* http://sec.gov/Archives/edgar/data/1129425/000119312510210085/dsc14d9.htm (company's description of the class actions).

139. *See* Amended Class Action Complaint, *supra* note 136, at ¶ 44.

140. *See* Recommendation Statement, *supra* note 138, at 38.

141. *See* Amended Class Action Complaint, *supra* note 136, at ¶ 37.

142. *See* Notice of Settlement of Class Action at 2, *In re* ZymoGenetics, Inc. S'holder Litig., No. 10-2-32389-9 (Wash. Super. Dec. 10, 2010), *available at* http://www.gilardi.com/pdf/zymgntcsnot.pdf.

plaintiffs, on the other hand, continued to believe in the merit of their claims, yet plaintiffs' counsel acknowledged the cost of continuing with the class action through trial and appeal, and the length of such proceedings, and determined that the settlement was in the best interests of the plaintiffs.[143] As part of the settlement agreement the company also agreed to pay plaintiffs' counsel $625,000 for attorneys' fees and expenses incurred in association with the prosecution.[144] Thus, the ZymoGenetics case shows that challenging the directors' decision to grant a top-up option as part of a tender offer is not an easy task, but one that can be expensive for the company.

Another example of a futile attempt to receive injunctive relief in an acquisition involving a top-up option is the case of Cogent Inc., a developer of automated fingerprint identification systems, which was acquired by the conglomerate 3M Company.[145] Here, too, the plaintiffs challenged the grant of the top-up option by the board not as part of appraisal proceedings prompted by the short-form merger, but rather beforehand as part of an attempt to stop the tender offer.[146] The plaintiffs argued that the planned sale of the company was tainted because key employees, including the CEO who was one of its founders and served as president and chairman of the board, were personally interested in the merger, which promised them retention agreements.[147]

There was, however, another potential acquirer of the company who had offered more for the company. The other potential acquirer was a competitor of Cogent.[148] Yet, the court agreed with Cogent's board that the deal with the competitor, which would require regulatory approval, involved a certain level of risk that justified preferring the deal with 3M despite the lower price.[149] The court also considered the fact that Cogent's chairman of the board had an exceptionally high equity interest in the company.[150] This high equity interest in the company, the court reasoned, made it unlikely for the manager to favor a lower priced deal just because the bidder promises him a relatively insignificant retention bonus.[151] Indeed, from a purely economic perspective, the increase in the purchase price would have more than covered the offered bonus in this case.

However, the likelihood that a manager would remain in charge of the operations of a company following a merger with a competitor

143. *Id.*
144. *Id.*
145. *In re* Cogent, Inc. S'holder Litig., 7 A.3d 487, 492 (Del. Ch. 2010).
146. *Id.*
147. *Id.* at 494 ("3M did make its offer contingent on entering into retention arrangements with key employees") (internal quotation marks omitted).
148. *Id.* at 495 (noting "Company D's status as Cogent's competitor").
149. *Id.* at 498.
150. *Id.* at 506 n.60.
151. *Id.* at 498.

seems less probable than the likelihood that his services would be needed if the company merged into an acquirer whose operations do not compete with the target. The difference in the expertise of the employees of the acquirer, 3M, and the target, Cogent, two companies that were not competitors and did not operate in the same market, made retention of the target's employees more likely.

Many founders value retention and remaining in control of the company not merely because of the continued pecuniary benefits they receive from the company, but also because controlling the company has an additional reputational and psychological value associated with the status of managing the company. This added value of continuing to manage the company is not easily quantifiable. For example, it was recently reported that Mark Zuckerberg, the founder and CEO of Facebook Inc., had declined an acquisition offer made by Microsoft, not because the offered price was too low, but merely because Mr. Zuckerberg was reluctant to relinquish control of Facebook.[152] Thus, in spite of the large equity interest that the manager of Cogent had in the sale of the company, he may well have had an additional interest in the identity of the acquirer and his possible future relationship with the company that may have also influenced his decision to support the sale to 3M.[153]

In refusing to grant a preliminary injunction, the court in *Cogent* explained that this remedy is issued only when the plaintiff can clearly show an "imminent irreparable harm."[154] The court was not convinced that this was a case of irreparable harm, relying in part on the availability of the appraisal remedy: "Fully informed stockholders may voluntarily choose not to tender their shares and instead seek appraisal under DGCL § 262."[155]

Following the Delaware Chancery Court's denial of the request for a preliminary injunction in the *Cogent* case, the impression among practitioners has been that "the use of top-up options is likely to present little litigation risk."[156] To be sure, this result is reassuring to both boards of targets who wish to support the friendly bidder and the bidder herself.[157]

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152. *See, e.g.*, Alexia Tsotsis, Microsoft: "Yeah, We Tried to Acquire Facebook.", TECHCRUNCH (Dec. 9, 2010), http://techcrunch.com/2010/12/09/fritz-lanman-microsoft-tried-to-acquire-facebook/ (quoting Mr. Zuckerberg telling Microsoft's CEO: "I don't want to sell the company unless I can keep control").

153. Additionally, in this case the manager is a billionaire and thus may have a diminished marginal utility of money.

154. *In re* Cogent, Inc. S'holder Litig., 7 A.3d 487, 513 (Del. Ch. 2010).

155. *Id.*

156. *See Top-Up Options – Looking Better and Better*, *supra* note 82.

157. Other attempts to enjoin a two-step acquisition with a top-up option on the grounds of breach of fiduciary duties, arguing that the top-up options interfere with shareholder voting rights and enable managment to avoid a judicial review of fiduciary duties in favor of mere appraisal procedures, were not viewed favorably by the court. *See, e.g.*, Olson v. ev3, Inc., No. 5583-VCL,

In the absence of a top-up option, a bidder who wishes to acquire the entire target company and freeze out all of the shareholders, but has not succeeded in owning at least 90% of the shares following the tender offer, can still proceed with her acquisition plan. After acquiring the majority of the shares in the tender offer, the bidder can buy out the minority shareholders who did not wish to participate in the tender offer in a subsequent merger. Owning less than 90% of the shares, however, forces the acquirer to conduct a statutory long form merger rather than a short-form merger. Owning the majority of the shares allows the acquirer to approve a merger.[158] Yet, owning the majority of the shares also transforms the acquirer into a controlling shareholder of the target, and thus subjects the subsequent merger to the enhanced and stringent fiduciary duty of entire fairness.[159]

A top-up option, on the other hand, converts the acquirer to a 90% shareholder and thus permits the use of a short-form merger. This transformation is critical, since it subjects the freeze-out merger only to the lax requirement[160] of a possible appraisal procedure. Thus, the top-up option allows the bidder to avoid entire-fairness review while freezing out the opposing shareholders, even without gaining the support of the holders of 90% of the target's shares.

Adding a top-up option enables the holder of the majority of the shares to avoid fairness review in a freeze out of the minority even without reaching the threshold of 90% of the company's equity. Ignoring the will of nontendering shareholders who together own only a trivial number of shares may, at times, be efficient and serve the interests of all the shareholders, including the nontendering ones. For example, it may be that a collective action problem is responsible for a few of the nontendered shares: some retail investors who did not tender may have done so only because they had not received the tender request or understood that they were asked to respond to the request. However, while this may explain

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2011 Del. Ch. LEXIS 34, at *6–8 (Del. Ch. Feb. 21, 2011) (reviewing a couple of earlier cases that either rejected the breach of fiduciary duty argument in the context of a top-up option or "described the plaintiffs' claims as far from compelling") (internal quotation marks omitted).

158. *See* DEL. CODE ANN. tit. 8, § 251(c) (2010) (requiring the approval of the holders of the majority of the shares for a long form merger).

159. *See, e.g.*, Guhan Subramanian, *Post-Siliconix Freeze-Outs: Theory and Evidence*, 36 J. LEGAL STUD. 1, 3 (2007) ("Freeze-outs are generally subject to entire-fairness review by the Delaware courts, a stringent standard of review because of their self-dealing nature. . . . Even procedural protections such as the use of [a special committee] or [a majority of the minority] condition serve only to shift the burden of proof of entire fairness to the plaintiff.").

160. *Cf. id.* at 4 ("Taken together, *Siliconix* and *Glassman* allow a controlling shareholder to avoid entire-fairness review by executing its freeze-out as a tender offer followed by a short-form merger.").

the behavior of a few shareholders, the closer we get to 50% nontendered shares the less likely it is that we face a collective action problem, but rather a different problem. Forcing the holders of more than 10% of the equity of the target out with only the lenient appraisal protection may not serve the collective good. In fact, as shown before, it may allow the bidder to pay the shareholders a lower price.[161]

Acquirers often prefer to use a tender offer followed by a short-form merger rather than a regular long-form merger. One of the main reasons why acquirers prefer the two-step acquisition of a tender offer and a subsequent short-form merger is that it takes less time to complete.[162] However, this expeditiousness may hurt the target's shareholders, who are left with less time to consider the transaction. Of even more concern is the fact that less time is left for competitors to enter the scene and compete with the bidder for the target.[163]

Not surprisingly, the use of a top-up option in tender offer acquisitions has dramatically increased since the middle of the last decade.[164] The ubiquity of the top-up option highlights the importance of the power to issue stock and also helps camouflage managerial attempts to abuse the power to issue stock through the grant of the option because it has become the custom.

3. The White Squire

Similar to the poison pill and the top-up option, a white squire is a technique that uses stock issuances to make sure the managers' wishes prevail despite shareholder opposition.[165] Managers use a white squire to prevent a hostile bid the shareholders may favor. Wishing to maintain their position with the corporation, the managers sell a block of shares to a friendly investor who subsequently opposes the hostile takeover and allows the managers

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161. *See supra* notes 101–05 and accompanying text.

162. *See, e.g.*, Mallea, *supra* note 11 ("Tender offers give acquirers several advantages over traditional one step transactions, particularly the speed at which the transaction can be completed and the option to use a short-form merger once more than 90% of the shares have been tendered in the offer.").

163. For the benefit of having more than one suitor, see, e.g., Karen Gullo & Adam Satariano, *Citigroup Accused by Terra Firma of Fraud Over Sale of EMI*, BLOOMBERG, (Dec. 12, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aVHdh52RtPOQ&pos=6 (describing the suit brought by Terra Firma Capital Partners Ltd. against Citigroup for allegedly misrepresenting that another bidder was interested in acquiring EMI Group Ltd.). In its complaint, Terra Firma argued it paid an inflated price for EMI because of Citigroup's alleged misrepresentation. *Id.*

164. *See, e.g.*, Mallea, *supra* note 11.

165. *See* Stephen R. Volk et al., *Developments in the Law of Mergers and Acquisitions: Developments in Defense*, *in* 577 CORP. L. & PRACTICE COURSE HANDBOOK SERIES 287, 324–25 (1987).

to keep their jobs.[166] Managers' entrenchment motives explain the use of a white squire in the shadow of a hostile takeover where blocking the change of control does not seem to coincide with the best interests of the shareholders.[167]

For example, the management of Walt Disney Productions used its power to issue stock, which enabled it to recruit a white squire as part of its resistance techniques aimed at fending off a hostile bidder.[168] In 1984, Disney faced the threat of a hostile bid for the company orchestrated by the corporate raider Saul Steinberg. Steinberg initiated the proposed takeover by acquiring a large toehold—an equity stake in Disney.[169] The management of Disney enlisted a friendly acquirer who purchased about 10% of Disney's shares in exchange for a land development firm that Disney bought.[170] The new block of shares issued to the friendly white squire diluted the hostile bidder and helped block the bidder's attempt to take over Disney.[171]

It should be noted that straight vote buying, that is, managers' use of the company's resources to control the outcome of a shareholder vote, is specifically limited. Shareholder voting

166. The white squire should be distinguished from a white knight. While both the white squire and the white knight support the target's management and help the management defend against a hostile bidder, the white knight is a friendly acquirer who directly competes with the hostile bidder for the whole target. *See* BLACK'S LAW DICTIONARY 1734 (9th ed. 2009) ("A person or corporation that rescues the target of an unfriendly corporate takeover, esp. by acquiring a controlling interest in the target corporation or by making a competing tender offer."). The white squire, on the other hand, buys only a stake in the target but does not offer to buy the whole company.

167. Incumbents who want to entrench themselves by issuing new shares will do it selectively and find an investor who is going to serve as a white squire and support them. The incumbents may not be able to rely on old white squires to continue to support them also in the future as the old investors may support the dissidents. This is one reason why the managers may want to make sure they can continue and issue new shares also in the future. To be sure, using a poison pill as an entrenchment mechanism does not bear this problem, since the managers apply their power to issue stock only as a deterrent, without actually issuing any shares or relying on new investors.

168. *See* Robert T. Grieves, B. Russell Leavitt & Adam Zagorin, *Greenmailing Mickey Mouse*, TIME (June 25, 1984), http://www.time.com/time/magazine/article/0,9171,926617,00.html.

169. *See id.*

170. *See id.* ("The strategy was to buy up other companies in order to diminish Steinberg's share of Disney. . . . Steinberg sued to stop the deal, but a U.S. district court in Los Angeles ruled in favor of Disney.").

171. *See, e.g.*, Al Delugach, *Walker Says He Was Unaware of Disney Strategy*, L.A. TIMES (July 06, 1989), http://articles.latimes.com/print/1989-07-06/business/fi-4208_1_disney-family ("[Disney] was putting 20% of its stock in the hands of Arvida's controlling shareholders, the billionaire Bass family of Texas . . . . [The "supermajority" provision of Disney's bylaws] stated that a takeover not favored by the board must be approved by holders of 80% of the company's stock.").

agreements are generally permitted.[172] However, in order to protect the shareholders from fraudulent behavior by management, the transfer of stock voting rights to management is prohibited if "the object or purpose is to defraud or in some way disenfranchise the other stockholders."[173] Such a transfer of voting rights is "a voidable transaction subject to a test for intrinsic fairness."[174] Instead of directly buying the vote, the managers create additional votes through their power to issue stock and distribute those newly created votes, along with the new shares, selectively. Thus, vote-buying effectively can take a less direct form, such as the use of a white squire or a top-up option, which is much more difficult to challenge.

D. Restrictions on the Power to Issue Shares

The previous Subpart showed that the power to issue stock can be exploited to the detriment of the shareholders. The power to issue stock serves as a significant building block for power tools in the managers' arsenal that can be used to circumvent the will of the shareholders. Understanding the contours of the power to issue stock can be crucial in assessing the effectiveness of the firm's corporate governance. Thus, this Subpart examines the restrictions on the managerial power to issue stock.

1. Quantitative Restrictions

As seen above, in Delaware the difference between the size of the authorized capital—predetermined in the company's certificate of incorporation—and the number of already issued shares, serves as an upper limit on how many shares management can issue without the shareholders' approval. In order to raise this ceiling, the certificate of incorporation of the company has to be amended to incorporate the increased number of authorized shares. Such amendment can only be done with shareholder approval. Provided there is a sufficient amount of authorized-and-unissued shares, however, Delaware corporate law does not restrict management's ability to issue shares.

There is no limit in Delaware on the size of the authorized capital that may be set in the certificate of incorporation.[175] A large capital may increase the fees that a corporation has to pay the

172. DEL. CODE ANN. tit. 8, § 218 (2010).

173. *See* Schreiber v. Carney, 447 A.2d 17, 25–26 (Del. Ch. 1982).

174. *Id.* at 26; *see also* Hewlett v. Hewlett-Packard Co., No. 19513-NC, 2002 Del. Ch. LEXIS 44, at *11–12 (Del. Ch. Apr. 8, 2002) ("Management . . . may not use corporate assets to buy votes in a hotly contested proxy contest about an extraordinary transaction that would significantly transform the corporation, unless it can be demonstrated . . . that management's vote-buying activity does not have a deleterious effect on the corporate franchise.").

175. DEL. CODE ANN. tit. 8, § 242(a) (2010).

Delaware Secretary of State because the fees are calculated based on the value of the corporation's capital.[176] The annual franchise tax, however, is capped and the maximum amount a Delaware corporation may be required to pay is $180,000 per year, a relatively insignificant expense for large public corporations.[177]

Other systems impose different quantitative restrictions on the power to issue stock without shareholder approval. For example, under the German Stock Corporation Act the total amount of authorized shares may be increased by the shareholders to allow management to issue new shares.[178] However, the total amount of authorized-but-unissued shares is limited to a maximum amount that should not exceed half the amount of the issued shares at the time of authorization by the shareholders.[179]

The listing requirements of stock exchanges provide another example of linking the higher limit of the amount of shares management can issue without asking for a new shareholder approval to the amount of issued shares. Both the New York Stock Exchange and NASDAQ listing rules cap the maximum number of shares that the managers can issue without going to the shareholders at 20% of the number of issued shares.[180] The experience with the listing rules' restrictions on the power to issue stock indicates that they may have a real effect on the corporate governance of companies.

For example, NASDAQ reported attempts by managers to coerce a favorable shareholder vote on issuances of shares through entering into agreements that provide that the company is penalized and the bidder rewarded if shareholders deny approval of additional issuances.[181] Such coercive transactions can stipulate a different price per share depending on the outcome of the shareholder vote: If the shareholders do not approve the transaction, then the investor will buy shares only up to the 20% cap in accordance with the listing rules, but will pay a much lower price per share than the price the investor would pay if the shareholders approve the issuance of more than 20% of the issued shares. NASDAQ has recognized such behavior as coercive and strictly enforces the 20% cap rule, rejecting any attempts to influence the shareholder vote and circumvent the

176. For the formula used to calculate the Delaware annual franchise tax, see *How to Calculate Franchise Taxes*, STATE OF DEL., http://corp.delaware.gov/frtaxcalc.shtml (last visited Sept. 15, 2011).

177. *Id.*

178. *See* Aktiengesetz [AktG] German Stock Corporation Act, Sept. 6, 1965, BGBL I at § 202(1).

179. *See id.*

180. *See supra* note 24 and accompanying text.

181. NASDAQ OMX Group, Inc., EQUITY RULE 5635, http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F1%5F4%5F2%5F8&manual=%2Fnasdaq%2Fmain%2Fnasdaq%2Dequityrules%2F (last visited Sept. 15, 2011).

20% cap rule.[182]

On the other hand, it may seem that the restrictions imposed by the listing rules fall short of the desired outcome in situations where the potential penalty for violating these restrictions, the delisting of the company, no longer poses a real threat to the company. For example, where management considers issuing a top-up option to a bidder that will result in the issuance of more than 20% of the company's shares without shareholder approval, it does not need to consider the outcome of delisting the company. Following the exercise of the top-up option and the subsequent short-form merger with the bidder, the company will no longer exist as a separate legal entity; thus, the threat of delisting becomes irrelevant. Not surprisingly, then, a top-up option agreement commonly states that lack of compliance with the stock exchange listing requirements does not release the company from its obligation to issue shares pursuant to the top-up option.[183]

2. Class Vote Restriction

A dual-class capital structure can be used in an attempt to circumvent the quantitative restrictions on the power to issue stock. Section 151(e) of the Delaware Code allows for the issuance of convertible shares.[184] A convertible share may be converted into a share of another class. For example, a convertible preferred share can be converted into a common share. Furthermore, the Delaware law permits the board of directors to set an exchange rate greater than one.[185] For example, one convertible preferred share can be converted into ten common shares. There is no statutory limit to the size of the conversion rate used for determining into how many common shares one convertible preferred share can be converted. Issuing preferred shares convertible into common stock at more than a 1:1 ratio can partially circumvent the limitation on the amount of shares that can be issued, which the maximum number of authorized shares of the company imposes.

182. *Id.* ("Nasdaq believes that in such situations the cap is defective because the presence of the alternative outcome has a coercive effect on the shareholder vote, and . . . will not accept a cap that defers the need for shareholder approval in such situations.").

183. *See, e.g.*, Section 1.4(a) of the Agreement and Plan of Merger and Reorganization between Rovi Corporation and Sonic Solutions at 13 (Dec. 22, 2010), *available at* http://sec.gov/Archives/edgar/data/1424454/000119312510287804/dex21.htm ("The obligation of the Company to issue and deliver shares pursuant to the Top-Up Option is subject only to the condition that no legal restraint (other than any listing requirement of any securities exchange) that has the effect of preventing the exercise of the Top-Up Option or the issuance and delivery of the Top-Up Option Shares in respect of such exercise shall be in effect.").

184. DEL. CODE ANN. tit. 8, § 151(e) (2010).

185. *Id.*

A sufficient amount of authorized-but-unissued common stock, however, is required for the conversion of the preferred stock into common stock. Indeed, it is common for venture capital funds, which invest through convertible preferred stock, to require that the company undertake to reserve common stock for the future conversion of the preferred stock into common stock and to keep a sufficient amount of unissued common stock for the conversion.[186] Yet, until the actual conversion takes place, the preferred stockholder can have the right to vote along with the common stockholders on an as converted basis, as if the preferred shares were converted into common shares, assigning more voting rights per one single preferred share than per one common share.

The Design Within Reach, Inc. example exemplifies the use of convertible preferred shares due to lack of authorized but unissued common stock.[187] In this case there were not enough authorized shares of common stock that could have been issued to Glenhill in exchange for its investment of $15 million in the company.[188] Instead, the company issued preferred shares convertible into common stock so that the investor owned about 91% of the company in a combination of common stock and convertible preferred stock, without a shareholder vote approving the stock issuance or any other part of the transaction.[189]

The ability of the augmented voting rights of the preferred shares to circumvent the quantitative restrictions on the power to issue stock is, however, also limited. If a class vote is required, a favorable vote by a majority of each class of shares separately is needed, and thus issuing preferred stock is not a good substitute for common stock. Approval of a short-form merger under Delaware law requires a class vote.[190] Under Delaware law a short-form merger requires owning at least 90% of each class of the voting shares and not just 90% of the aggregated rights to vote as one

186. *See, e.g.*, the Model Stock Purchase Agreement of the National Venture Capital Association §2.5, http://nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136 (last visited Sept. 15, 2011) (providing that "[t]he Common Stock issuable upon conversion of the Shares has been duly reserved for issuance.")

187. *See* Letter from Brian E. Covotta, O'Melveny & Myers LLP, in response to comment letter for Securities and Exchange Commission, *available at* http://sec.gov/Archives/edgar/data/1116755/000119312509220615/filename1.htm (last visited Sept. 15, 2011).

188. *See id.*

189. *See id.* ("Because the Company did not have sufficient authorized shares of common stock, the Investor purchased . . . the Company's remaining authorized shares . . . and 1,000,000 shares of a new series of Series A Convertible Preferred Stock . . . convertible into a number of shares of the Company's common stock such that . . . [it] will, in the aggregate, represent 91.33% of the Company's outstanding common stock.").

190. DEL. CODE ANN. tit. 8, § 253 (2010).

group.[191] As discussed above, short-form merger is the ultimate step in the top-up option scheme.[192] Thus, a top-up option requires the issuance of a substantial number of common shares and cannot rely on a dual-class capital structure.[193]

Unlike the top-up option, the poison pill can, in theory, rely on the issuance of only blank-check preferred stock[194] if the certificate authorized the managers to issue such class of preferred stock that is assigned higher voting rights and distribution rights than the common stock. It is, however, common practice to have a poison pill that uses preferred stock convertible into common stock and thus still requires a large amount of common shares for the conversion. In addition, poison pills often include a provision that explicitly allows the company to distribute cash, assets, and other securities instead of common stock, if the company does not have sufficient common stock when the poison pill is triggered.[195] The poison pill is intended to deter a hostile takeover by credibly threatening the dilution of the value of the hostile bidder and not merely its voting rights. Thus, the technique of replacing share distribution with asset distribution, in this case, can effectively circumvent a limit requirement on the number of shares management can issue without going back to the shareholders. Yet, this technique will not suffice where the desired stock distribution is mainly aimed at increasing the voting rights of the intended recipients of the shares, as in the case of a top-up option where the bidder still needs to own 90% of each class of shares to be able to perform a short-form merger.

3. Qualitative Restriction

The previous Subpart illustrated the deficiencies of challenging management's use of the power to issue stock in court. It is very

191. *Id.*

192. *See supra* notes 85–90 and accompanying text.

193. It should be noted that unlike Delaware, California, as well as a few other jurisdictions that follow the Model Business Corporation Act, requires a class vote to approve a regular statutory long form merger. *See, e.g.*, CAL. CORP. CODE § 1201(a) (2009).

194. If the charter includes a blank check preferred stock provision, the board of directors has full discretion to determine the rights assigned to these shares in accordance with section 102(a)(4) of the Delaware General Corporation Law. *See* DEL. CODE ANN. tit. 8, § 102(a)(4) (2010).

195. The customary language in poison pills agreements provides that: "In the event that the Company does not have sufficient Common Shares available for all Rights to be exercised, . . . the Company may instead substitute cash, assets or other securities for the Common Shares for which the Rights would have been exercisable under this provision." Corvel Corp. Registration (Form 8-A12G/A) (Nov. 24, 2008), http://sec.gov/Archives/edgar/data/874866/000089256908001502/a50604e8va12gza.htm; *see also* Sun Microsystems Inc. Registration (Form 8-A12G/A) (Sept. 26, 2002), http://sec.gov/Archives/edgar/data/709519/000089161802004446/f83627a0e8va12gza.htm.

difficult to prove that the purpose of a specific stock issuance lacks good faith and breaches the fiduciary duties of the managers. In addition, the previous Subpart discussed the shortcomings of the remedy of appraisal, which may be the only available remedy following the issuance of the shares.[196]

Attempts to limit managers' general ability to issue stock only to ordinary, nonorganic purposes, such as financing ordinary business operations of the company, have failed. In *Moran v. Household International*, the Delaware Supreme Court[197] rejected an interpretation of the Delaware statute that limits managers' power to issue securities only for corporate finance related purposes.[198] The court has explicitly allowed managers to use their power for nonfinance related purposes such as corporate control related issuances.[199] In a recent case, following the Delaware Supreme Court in *Moran*, the Delaware Chancery Court upheld a record long use of a poison pill[200] that prevented a hostile takeover.[201]

4. Preemptive Rights Restriction

Preemption rights allow the shareholders to participate pro rata in any distribution of shares by the company.[202] The following example illustrates how preemptive rights work. A company has issued 100 shares and plans to issue another 10 new shares. Assuming a shareholder has preemptive rights and currently holds 10% of the company, she is entitled to purchase one newly issued share, which represents 10% of the total amount of new shares being issued by the company. Should the shareholder choose to exercise her preemptive right and purchase the new share, she will then own a total of 11 shares out of the 110 shares of the company,

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196. As in the case of a short-form merger, *see supra* note 97 and accompanying text.

197. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1351 (Del. 1985) ("Appellants are unable to demonstrate that the legislature, in its adoption of § 157, meant to limit the applicability of § 157 to only the issuance of Rights for the purposes of corporate financing. Without such affirmative evidence, we decline to impose such a limitation upon the section that the legislature has not.").

198. *See id.*

199. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 492 A.2d 946 (1985).

200. *See* Air Prods. & Chems., Inc. v. Airgas, Inc., Nos. 5249-CC & 5256-CC, 2011 Del. Ch. LEXIS 22, at *12 (Del. Ch. Feb. 15, 2011) ("[The poison pill] has given Airgas *more time than any litigated poison pill in Delaware history* . . . .") (emphasis in original).

201. *See, e.g.*, Gina Chon, *"Poison Pill" Lives as Airgas Wins Case*, MARKETWATCH (Feb. 16, 2011), http://www.marketwatch.com/story/story/print?guid=42cccb5a-395a-11e0-a9aa-012128040cf6 ("Minutes after the judge's ruling, Air Products dropped its effort to buy Airgas.").

202. *See* Andrew L. Nichols, *Shareholder Preemptive Rights*, 39 BOS. BAR J. 4, 4 (1995).

maintaining her 10% holding in the company.

If the shareholders exercise their preemptive rights, they will maintain their percentage holding in the company and prevent dilution by the issuance of new shares. To the extent that the shareholders have preemptive rights and exercise these rights fully each time the company issues new shares, management's ability to issue shares cannot circumvent the shareholders' will, rendering corporate mechanisms such as a poison pill and a top-up option futile.

Preemptive rights are no longer mandatory in the United States.[203] Other jurisdictions, on the other hand, still treat preemptive rights as a basic mandatory right of the shareholders and enforce stringent restrictions on the ability to waive these rights. For example, under the German Stock Corporation Act preemptive rights are mandatory and can be waived only if the company issues no more than 10% of the issued capital and provided that at least 75% of the shareholders' votes approve the waiver.[204]

However, preemptive rights give only the right to participate in future issuances of shares, but the shareholders' ability to participate in the issuance of shares may in itself be limited. Participation in a distribution of shares requires paying for the newly issued shares. Liquidity constraints, as well as collective action problems, can prevent shareholders from exercising preemptive rights. A shareholder may not want or be able to invest more in the company and may prefer, for example, to diversify her investment and use any available funds to pursue a different business opportunity. This weakness of preemptive rights may explain why venture capital investors, who customarily require preemptive rights as a condition for their investment in private firms, also negotiate for the right to acquire more shares in new issuances if other existing shareholders fail to exercise their preemptive rights and purchase their entire pro rata share.[205]

203. *See, e.g.*, John C. Coffee Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on The Judicial Role*, 89 COLUM. L. REV. 1618, 1641 (1989) ("Preemptive rights . . . [was] a rule that was once mandatory, but evolved into a default rule.").

204. *See* Aktiengesetz [AktG] German Stock Corporation Act, Sept. 6, 1965, BGBL I at § 202; Dr. Hurbert Besner et al., *How to Implement a Standard US Venture Capital Term Sheet in Germany* (Jan. 21, 2002), http://www.altassets.com/private-equity-knowledge-bank/country-focus/europe/western-europe/germany/article/nz2955.html.

205. *See, e.g.*, the Model Investors' Rights Agreement of the National Venture Capital Association at 25 n.42, http://nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136 (last visited Sept. 15, 2011) (explaining that this is "commonly referred to as a[n] . . . 'over allotment' . . . provision and allows investors to purchase shares not purchased by other investors entitled to purchase rights").

II. THE EXCESS RATIO

After reviewing the key aspects of management's power to issue stock and analyzing possible implications of this power, I now turn to study the magnitude of the managers' power to issue stock empirically. As seen above, one of the major limitations on this power is the size of the authorized capital of the corporation, which provides a ceiling for the total number of shares that can be issued without shareholder approval.[206] The relative size of the number of authorized shares versus the number of shares already issued determines the extent of management's power to issue shares. Thus, the ratio of the authorized shares not outstanding to the already-issued-and-outstanding shares, what I shall call the "excess ratio," is an indicator of the magnitude of the managers' power to issue stock.

For example, an excess ratio of one signifies that there are enough authorized-but-not-outstanding shares to double the number of shares already issued and outstanding. The stock exchanges' requirement of shareholder approval for an increase of more than 20% of the issued share is equivalent to a 0.2 excess ratio,[207] and the German limit of 50% can be expressed as a 0.5 excess ratio.[208]

A study of initial public offerings of nonfinancial companies[209] incorporated in Delaware reveals that companies choose to go public with a significantly high excess ratio. I use the data in prospectuses of nonfinancial Delaware companies, which were filed with the Securities and Exchange Commission, to calculate the excess ratios of the companies at the time of the initial public offering. In 2009, the average excess ratio of the companies in my sample was 5.79 and the median ratio was 3.75. This high excess ratio allows the management of the firms to more than quadruple the number of issued shares without asking the shareholders for their approval to issue more stock.[210] Similar results were obtained when the excess

206. *See supra* notes 34–40 and accompanying text.

207. *See supra* note 24 and accompanying text.

208. *See supra* notes 178–79 and accompanying text.

209. I study only nonfinancial companies because financial companies, including real estate investment trusts ("REITs"), are subject to additional regulatory governance requirements that may have a substantial effect on the choice of the size of the excess ratio. *See, e.g.*, Lucian Arye Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 418 (2005) (excluding REITs from the sample because such corporations "have their own special governance structure and entrenching devices"); Robert Daines, *Does Delaware Law Improve Firm Value*?, 62 J. FIN. ECON. 525, 530 (2001) (omitting financial firms from the tested sample because the special federal regulations may influence the corporate governance of such firms).

210. To be sure, this assumes that the managers ignore stock exchange restrictions on issuance of shares without shareholder approval, as they often do where top-up options are granted. *See supra* note 183 and accompanying text.

ratio was measured for companies that went public in 2008. The excess ratio, at the time of the initial public offering, of companies that went public in 2003 was also checked since the use of the top-up option, which requires a high excess ratio, has increased since 2004.[211] The average ratio of firms that went public in 2003 was also significantly high and only slightly lower than in more recent years. The study found a substantial deviation in the excess ratio: some companies choose to go public with an exceptionally high ratio and the highest ratio in the sample was 25. Other companies choose to have a relatively low ratio—the lowest in the sample was 0.34. The following table summarizes these findings.

TABLE 3: EXCESS RATIOS

Year	Mean Excess Ratio	Median Excess Ratio	Standard Deviation	Sample Size
2009	5.79	3.75	5.13	28
2008	4.74	3.17	5.87	16
2003	4.55	3.26	3.08	37

The study also looked at venture-backed firms separately. On the one hand, venture capitalists customarily restrict the managers' ability to issue shares at the private stage of the company.[212] This indicates that these sophisticated investors are aware of the importance of the managers' power to issue stock. On the other hand, venture capitalists may be inclined to enable management to issue a top-up option because of the typical, relatively short-run focus of these investors.[213] The excess ratio of the venture-backed firms was slightly higher than that of nonventure-backed firms that went public in the same year. However, the study did not find a statistically significant difference between the excess ratio of the two sets of firms, suggesting that the use of a high excess ratio is not unique to venture-backed firms.

The study found that the use of a high ratio at the time of an initial public offering is prevalent, yet there was no statistical indication that the size of the firm is related to the size of the ratio.[214] In the years following the public offering, the excess ratio of

211. *See supra* note 164 and accompanying text.

212. *See, e.g.*, D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 319–20 (2005).

213. *See, e.g.*, *id.* at 345 (explaining that "[e]xit is not merely optional for venture capitalists. Most venture capital funds have a fixed life, usually ten years with an option to extend for a period up to three years").

214. The size of the assets of the company may influence the choice of the size of the excess ratio at the public offering, because the size of the company may be connected to the likelihood of a future takeover. An acquirer needs less

the firms declined if management issued additional shares. However, the average excess ratio of venture backed firms that went public in 2004 was notably high 5 years following the public offering, and was on average 3.15. This finding may suggest that the high ratio is not used for regular stock issuances, either because they are not required or because managers are cautious about weakening their power to dilute the shareholders in the future by issuing in the present.

In addition, the study checked for a relation between the size of the excess ratio at the time of the initial public offering and the likelihood of a future acquisition. The study looked at the 83 venture-backed companies that went public in 2004. Out of these companies, 29 were acquired by the end of 2010. A check for a relation between the excess ratio and the likelihood of future acquisitions did not find a statistically significant correlation between the two. It should be noted, however, that even though a high excess ratio may have an influence on whether the company is acquired or stays independent, a high excess ratio helps management in both opposing directions. On the one hand, a high ratio may help management sell the company through the use of a top-up option, and on the other hand, the high ratio may help management prevent a sale through the use of a poison pill or a white squire.

The following table summarizes the mean and median excess ratio of 264 venture-backed Delaware firms that went public in the years 2004–2009.

TABLE 4: AVERAGES OF MEAN AND MEDIAN EXCESS RATIOS

Excess Ratio	2004	2005	2006	2007	2008	2009	All
Mean	6.16	4.61	4.69	4.85	7.31	3.16	5.21
Median	3.82	3.48	3.58	3.99	5.08	3.50	3.69

CONCLUSION

This Article studied the important managerial power to issue stock and shows that shareholders are vulnerable to managers exploiting this power to promote their own self-interest. On the one hand, the power to issue stock can be used to create entrenchment

financing to purchase a small firm, thus there are more potential acquirers that can acquire small firms, suggesting that smaller firms may have a higher incidence of being acquired. In addition, a bigger company may be subject to more monitoring at the time of the initial public offering as well as later on. The heightened scrutiny may limit the ability of management to go public with a high ratio and also limit the use of the power to issue stock in the future, even if there are sufficient authorized but unissued shares.

mechanisms that prevent a sale of the company, and on the other hand, it can help form mechanisms that promote the sale of the company despite significant shareholder opposition.

Even though there are limitations on the managers' power to issue stock, this Article shows that most of these limitations do not effectively restrict this power and that managers can still take advantage of it to advance their own interests. Furthermore, the only restriction that can effectively prevent the managers from issuing substantial amounts of shares without receiving the shareholders' approval—the ceiling set by the number of authorized shares—can distort managerial behavior. This limit on the power to issue stock may influence the managers to refrain from issuing stock for ordinary business purposes, such as equity financing and performance based compensation, in order to retain their power.

A study of a proxy for the magnitude of the power to issue stock, as is measured by the excess ratio, revealed that companies tend to go public with a significantly high ratio that allows management to more than quadruple the amount of issued shares without shareholder approval. This incidence of a high ratio, which indicates a significant power in managers' hands, can be desirable to the extent that it allows the managers to issue stock without worrying about diminishing their power. On the other hand, mechanisms such as a top-up option require the issuance of such a substantial amount of new shares that managers may nonetheless remain cautious about share issuances despite a high excess ratio.

Further study of the excess ratio may enhance our understanding of corporate governance and of managerial decision-making processes. Such a study may look at a possible relation between personal characteristics of management and the size of the ratio. In addition, a study of a possible correlation between the size of the excess ratio and the existence of entrenchment mechanisms may expose interesting patterns, since the excess ratio can serve as an alternative or as a complementary tool. Similarly, a study of the correlation between the excess ratio and the existence of tools aimed at monitoring management, such as independent directors, can increase our understanding of corporate governance.