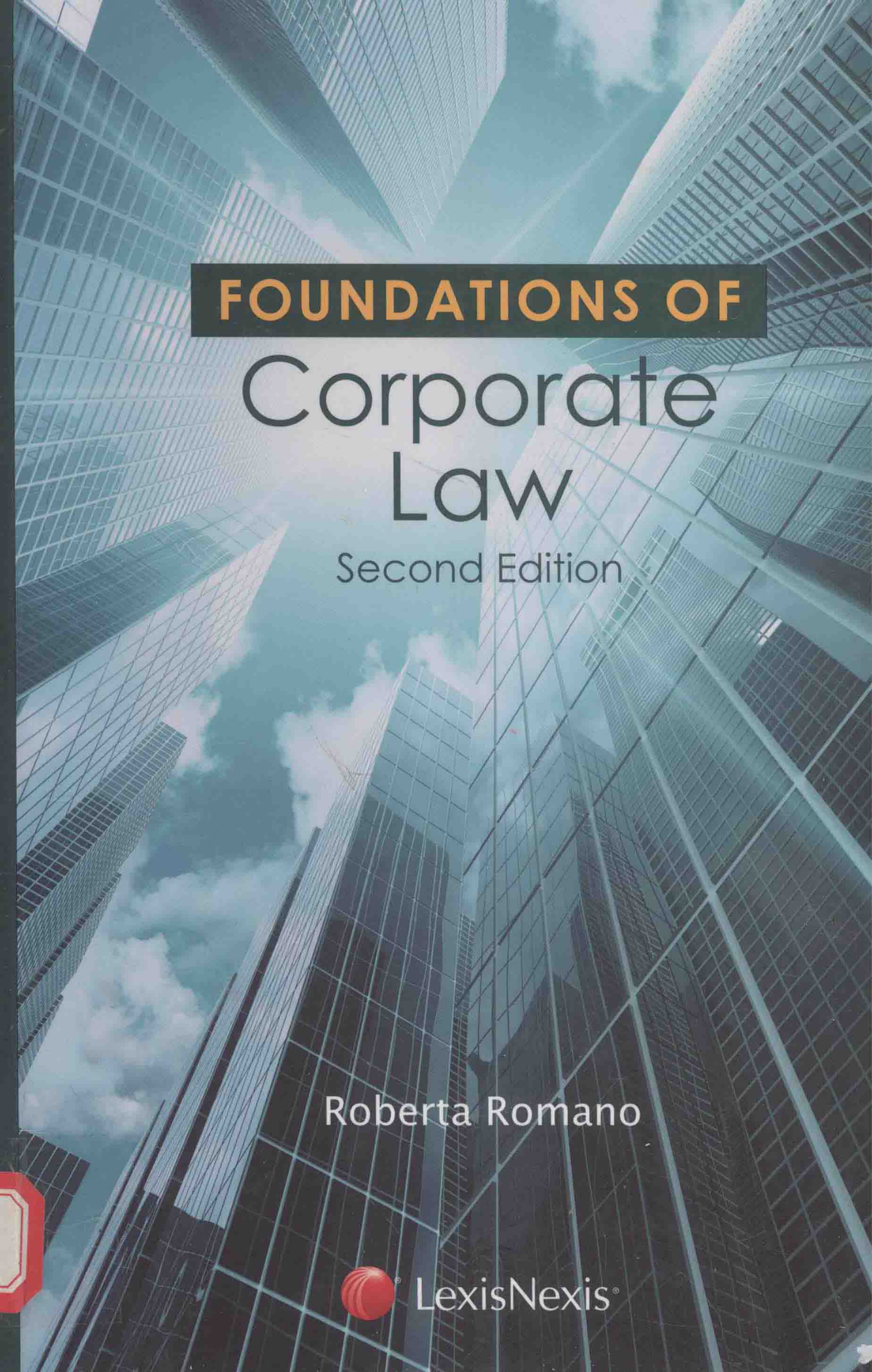

FOUNDATIONS OF Corporate Law

Second Edition

Roberta Romano

LexisNexis®

FOUNDATIONS OF CORPORATE LAW

SECOND EDITION

Roberta Romano

Oscar M. Ruebhausen Professor of Law
Yale Law School

LexisNexis™
Matthew Bender®

ISBN: 9781422499382

NOTE TO USERS

To ensure that you are using the latest materials available in this area, please be sure to periodically check the LexisNexis Law School web site for downloadable updates and supplements at www.lexisnexis.com/lawschool.

Editorial Offices
121 Chanlon Rd., New Providence, NJ 07974 (908) 464-6800
201 Mission St., San Francisco, CA 94105-1831 (415) 908-3200
www.lexisnexis.com

(Pub.3342)

PREFACE TO THE SECOND EDITION

The revolution in corporate law that led me to assemble the first edition of this reader has not only continued unabated but also has quickened in the intervening decade plus years, bringing a far greater sophistication in the use of finance and organizational economics in corporate law scholarship and practice. In the years since the first edition's publication, the field has expanded to confront new substantive issues, and deepened as attention has refocused on corporate governance in the wake of the financial accounting scandals of high-profile firms in 2001–02, such as Enron, Worldcom and Parmalat. Moreover, corporate law scholarship and practice have expanded geographically, both because of the international scope of the scandals and because of a profusion of cross-border transactions and global investments, which have spurred the diffusion of U.S.-type business transactions and legal rules across the globe. The second edition reflects these trends, expanding the original chapter on internal governance mechanisms into three separate chapters on distinctive components of governance: boards of directors and their fiduciary liability; voting and other forms of institutional investor activism; and executive compensation and adding a new chapter on comparative corporate governance.

Users of the prior edition will find that there is considerable new excerpted material in every chapter but the chapter on limited liability; still, even that chapter has fully updated notes and questions, as do all the others. This has necessarily made for a considerably longer book. For example, the theory of capital markets section of chapter one includes excerpts on behavioral finance, which provides the theoretical underpinning of new substantive material, such as the Langevoort excerpt on boards of directors in chapter five. More recent debates over the need to increase shareholder power and to rein in executive compensation are excerpted in readings in chapters six and seven. In addition to new debates, there are selections that take fresh looks at ongoing controversies in the first edition, such as whether states compete over charters in chapter three, who benefits from shareholder litigation in chapter five, and the efficacy of the federal securities laws, in chapter nine.

Although I have a point of view on a number of these issues, as the excerpts from my contributions indicate, as in the first edition, I have tried my best to counter my perspective, and that of others, by juxtaposing differing viewpoints throughout the reader. My belief is that such an approach should make for both a better and more enjoyable educational experience. I have further followed the same editorial approach to the material as taken in the prior edition, favoring accessibility and breadth, by considerable editing of the original articles, along with suppression of most mathematics, footnotes, and references, recognizing that this risks loss of the subtlety or complexity of arguments, and technical or bibliographic precision, and compensating, hopefully, by the inclusion of extensive notes and questions related to the wider literature. If the book serves to pique the reader's interest to delve further into the original material to follow up on theories, evidence and references, then the tradeoff, in my mind, will have been well served.

A final note on the reader's format is in order. In addition to continuing the practice described in the preface to the first edition, in this edition, nearly all ellipses at the beginning and end of paragraphs have been omitted. This has been done to further the objective of the other formatting decision rules, to improve the book's readability.

R.R.

New Haven, July 2010

PREFACE

Corporate law underwent a revolution over the past decade. In the midst of an extraordinary period of innovation in business organization and acquisitive activity, legal scholarship was transformed by the use of the new analytical apparatus of the economics of organization and modern corporate finance. This learning has already had, and will increasingly have, a profound impact on corporate practice and, accordingly, on the teaching of corporate law. This book of readings seeks to provide an accessible introduction to the enduring policy debates in corporate law as well as the intuition for the fundamental economic concepts of the new learning that informs the debates. In addition, a concerted effort has been made to provide a realistic sense of the institutional landscape, which is foreign to many students, by extensive referencing of the burgeoning empirical research on corporate governance.

The key feature of the public corporation is Adolph Berle and Gardiner Means' insight concerning the separation of ownership and control: managers of the firm, who run the business, are not the owners. This separation creates a host of organizational problems, because managers' incentives are not always aligned with the owners' interest; such problems are generically referred to as agency problems. Much of corporate law is directed at mitigating agency problems, as selections in the reader illustrate. The readings also indicate how the economic theory of organization as well as corporate finance clarify different facets of the agency problem and suggest ways of mobilizing the legal system to address this master problem.

A word on the reader's format is in order. I have used materials in this reader as a supplement to casebooks in my courses in corporate law and corporate finance. The reader was crafted with the intention that it be used as a springboard for class discussion in a corporations course, but there are extensive notes and questions to ensure that it is sufficiently self-contained for independent, self-directed use. All of the selections have been extensively edited to facilitate accessibility. Mathematics appearing in original works has been suppressed, although simple numerical examples have been retained or included in the notes to illustrate concepts. A danger with such an approach is that complexities of the literature can easily be lost, and this may convey the misimpression that there is no ambiguity to policy-making. I have sought to temper this risk by juxtaposing sharply differing positions in the selections or accompanying notes. In addition, references and most footnotes have been omitted from excerpts. Precision and bibliographic convenience have been sacrificed for the pedagogic benefit of greater readability. Readers who are sufficiently intrigued by an excerpt can follow up on arguments and references by recourse to the original source.

This book would not have been completed without the superb assistance of Cathy Briganti and the unflagging encouragement and support of Albert Romano. I cannot begin to thank them; I can only end by acknowledging that fact.

R.R.

New Haven, October 1992

LexisNexis Law School Publishing Advisory Board

CONTENTS

1 *Theory of the Firm and Capital Markets, 1*

A *Theory of the Firm*, 5

Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 5
Michael C. Jensen and William H. Meckling

Transaction Cost Economics, 10
Oliver E. Williamson

Ownership of the Firm, 16
Henry Hansmann

Firms, Contracts, and Financial Structure, 23
Oliver Hart

A Political Theory of American Corporate Finance, 29
Mark J. Roe

Notes and Questions, 33

B *Theory of Capital Markets*, 40

A Random Walk Down Wall Street, 40
Burton G. Malkiel

Corporate Finance, 52
Stephen A. Ross, Randolph W. Westerfield and Jeffrey F. Jaffe

Event Studies and the Law: Part I: Technique and Corporate Litigation, 65
Sanjai Bhagat and Roberta Romano

A Random Walk Down Wall Street, 72
Burton G. Malkiel

Notes and Questions, 80

2 *Legal Characteristics of the Corporation: Limited Liability, 90*

Limited Liability and the Corporation, 92
Frank H. Easterbrook and Daniel R. Fischel

Limited Liability in the Theory of the Firm, 99
Susan E. Woodward

Toward Unlimited Shareholder Liability for Corporate Torts, 102
Henry Hansmann and Reinier Kraakman

Notes and Questions, 107

3 *The Production of Corporation Laws, 114*

A *State Competition for Corporate Charters*, 117
The State Competition Debate in Corporate Law, 117
Roberta Romano
Toward an Interest Group Theory of Delaware Corporate Law, 123
Jonathan R. Macey and Geoffrey P. Miller
The Myth of State Competition in Corporate Law, 126
Marcel Kahan and Ehud Kamar
Delaware's Competition, 130
Mark Roe
Uncorporations and the Delaware Strategy, 132
Saul Levmore
Notes and Questions, 139
B *The Structure of Corporation Laws*, 152
The Corporate Contract, 152
Frank H. Easterbrook and Daniel R. Fischel
The Mandatory Structure of Corporate Law, 160
Jeffrey N. Gordon
The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role, 167
John C. Coffee, Jr.
What Do Corporate Default Rules and Menus Do? An Empirical Examination, 169
Yair Listokin
Notes and Questions, 174

4 *Financing the Corporation, 183*

On Financial Contracting: An Analysis of Bond Covenants, 185
Clifford W. Smith, Jr., and Jerold B. Warner
Contractual Resolution of Bondholder—Stockholder Conflicts in Leveraged Buyouts, 192
Kenneth Lehn and Annette Poulsen
Active Investors, LBOs, and the Privatization of Bankruptcy, 194
Michael C. Jensen
The Structure and Governance of Venture Capital Organizations, 196

William A. Sahlman
Two Agency–Cost Explanations of Dividends, 201
Frank H. Easterbrook
Notes and Questions, 203

5 *Internal Governance Structures: Boards of Directors, 217*

A *Boards of Directors*, 219
Corporate Governance, 219
Oliver E. Williamson
Empirical Studies of Corporate Law, 226
Sanjai Bhagat and Roberta Romano
The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability, 228
Donald C. Langevoort
Notes and Questions, 237

B *Director Liability for Breach of Duty*, 246
The Shareholder Suit: Litigation Without Foundation?, 246
Roberta Romano
The New Look of Shareholder Litigation: Acquisition–Oriented Class Actions, 257
Robert B. Thompson and Randall S. Thomas
File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions, 270
Elliott J. Weiss and Lawrence J. White
The Public and Private Faces of Derivative Lawsuits, 277
Robert B. Thompson and Randall S. Thomas
Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market, 280
Tom Baker and Sean J. Griffith
The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer, 292
Tom Baker and Sean J. Griffith

Does "Unlawful" Mean "Criminal"?: Reflections on the Disappearing Tort/Crime Distinction in American Law, 301
John C. Coffee, Jr.
Corporate Crime Legislation: A Political Economy Analysis, 307
Vikramaditya S. Khanna
Notes and Questions, 315

6 ***Internal Governance Structures: Shareholder Voting and Exercise of Voice, 329***

A *Shareholder Voting Rights*, 331
Voting in Corporate Law, 331
Frank H. Easterbrook and Daniel R. Fischel
Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 337
Jeffrey N. Gordon
The Case for Increasing Shareholder Power, 341
Lucian Arye Bebchuk
Director Primacy and Shareholder Disempowerment, 353
Stephen M. Bainbridge
The Mythical Benefits of Shareholder Control, 356
Lynn A. Stout
The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership, 360
Henry T.C. Hu and Bernard Black
Notes and Questions, 364

B *Exercising Voice: Institutional Investors in Action*, 372
Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance, 372
Roberta Romano
Hedge Funds in Corporate Governance and Corporate Control, 384
Marcel Kahan and Edward B. Rock
Hedge Fund Activism, Corporate Governance, and Firm Performance, 393
Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas
Fiduciary Duties for Activist Shareholders, 397

Iman Anabtawi and Lynn Stout
The Promise and Peril of Corporate Governance Indices, 403
Sanjai Bhagat, Brian Bolton and Roberta Romano
Notes and Questions, 410

7 *Internal Governance Structures: Executive Compensation, 426*

Executive Compensation, 427
Kevin J. Murphy
Incentive and Tax Effects of Executive Compensation Plans, 433
Clifford W. Smith, Jr. and Ross L. Watts
Pay without Performance: Overview of the Issues, 437
Lucian A. Bebchuk and Jesse M. Fried
Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis", 448
Jeffrey N. Gordon
Pay without Performance and the Managerial Power Hypothesis: A Comment, 457
Bengt Holmstrom
"Empowering Shareholders on Executive Compensation" and H.R. 1257, the "Shareholder Vote on Executive Compensation Act," 464
Steven N. Kaplan
Say on Pay Votes and CEO Compensation: Evidence from the UK, 468
Fabrizio Ferri and David Maber
Notes and Questions, 472

8 *External Governance Structure: The Market for Corporate Control, 488*

A *Theories and Evidence*, 491
Mergers and the Market for Corporate Control, 491
Henry G. Manne
Takeovers: Their Causes and Consequences, 492
Michael C. Jensen
Risk Reduction as a Managerial Motive for Conglomerate Mergers, 495

Yakov Amihud and Baruch Lev
The Hubris Hypothesis of Corporate Takeovers, 496
Richard Roll
The Market for Corporate Control: The Empirical Evidence Since 1980, 500
Gregg A. Jarrell, James A. Brickley and Jeffry M. Netter
Hostile Takeovers in the 1980s: The Return to Corporate Specialization, 503
Sanjai Bhagat, Andrei Shleifer and Robert W. Vishny
New Evidence and Perspectives on Mergers, 505
Gregor Andrade, Mark Mitchell and Erik Stafford
Leveraged Buyouts and Private Equity, 515
Steven N. Kaplan and Per Strömberg
Notes and Questions, 526

B *Management's Fiduciary Duty and Takeover Defenses*, 546
The Proper Role of a Target's Management in Responding to a Tender Offer, 546
Frank H. Easterbrook and Daniel R. Fischel
Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense, 550
Ronald J. Gilson
The Case for Facilitating Competing Tender Offers: A Reply and Extension, 553
Lucian A. Bebchuk
The Market for Corporate Control: The Empirical Evidence Since 1980, 555
Gregg A. Jarrell, James A. Brickley and Jeffry M. Netter
The Wealth Effects of Second–Generation State Takeover Legislation, 560
Jonathan M. Karpoff and Paul H. Malatesta
The Future of Hostile Takeovers: Legislation and Public Opinion, 566
Roberta Romano

Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs, 573
Robert Daines and Michael Klausner

Notes and Questions, 582

9 *Securities Regulation, 600*

A *Disclosure Regulation*, 603
Mandatory Disclosure and the Protection of Investors, 603
Frank H. Easterbrook and Daniel R. Fischel
Market Failure and the Economic Case for a Mandatory Disclosure System, 609
John C. Coffee, Jr.
Measuring the Costs and Benefits of Regulation: Conceptual Issues in Securities Markets, 611
J. Harold Mulherin
Mandatory Disclosure as a Solution to Agency Problems, 619
Paul G. Mahoney
Securities Fraud as Corporate Governance: Reflections upon Federalism, 629
Robert B. Thompson and Hillary A. Sale
Notes and Questions, 636

B *Insider Trading Regulation*, 646
Insider Trading, Rule 10b–5, Disclosure, and Corporate Privacy, 646
Kenneth E. Scott
The Regulation of Insider Trading, 650
Dennis W. Carlton and Daniel R. Fischel
Substitutes for Insider Trading, 653
Ian Ayres and Joe Bankman
Notes and Questions, 661

C *Who Should Regulate?*, 668
Empowering Investors: A Market Approach to Securities Regulation, 668
Roberta Romano
The Exchange as Regulator, 678
Paul G. Mahoney
Regulating Investors Not Issuers: A Market–Based Proposal, 686
Stephen Choi
The SEC, Retail Investors, and the Institutionalization of

the Securities Markets, 695
Donald C. Langevoort
Notes and Questions, 700

10 Comparative Corporate Law, 705

Legal Determinants of External Finance, 706
Rafael La Porta, Florencio Lopez–De–Silanes, Andrei Shleifer and Robert W. Vishny
The Economic Consequences of Legal Origins, 713
Rafael La Porta, Florencio Lopez–De–Silanes and Andrei Shleifer
A Self–Enforcing Model of Corporate Law, 725
Bernard Black and Reinier Kraakman
The Legal and Institutional Preconditions for Strong Securities Markets, 729
Bernard S. Black
A Theory of Path Dependence in Corporate Governance and Ownership, 741
Lucian Ayre Bebchuk and Mark J. Roe
The End of History for Corporate Law, 747
Henry Hansmann and Reinier Kraakman
Notes and Questions, 757

1

Theory of the Firm and Capital Markets

The readings in this chapter provide a framework for understanding corporate law. The selections in part A on the theory of the firm are classic contributions that provide explanations of why individuals organize their economic activity into firms and why certain institutional arrangements are so prevalent. They also suggest that the markets in which firms operate affect their organizational structures. A key market for public corporations is the capital market. This is because one of the explanations for organizing a business as a corporation is its greater access to capital, which, as discussed in Chapter 2, is facilitated by corporate characteristics of free transferability of shares and limited liability. The selections in part B introduce the conceptual building-blocks of modern corporate finance. It is not possible to understand the operation of capital markets, and correlatively the corporations whose securities trade in those markets, without a mastery of those rudimentary ideas.

In neoclassical economics, the firm is a black box, represented by a production function. Although firms have an objective, profit maximization, the neoclassical approach focuses on aggregate firm behavior (markets) rather than the individual firm. The readings in this chapter on the theory of the firm, however, take a more microanalytical approach, delving inside the firm and differentiating the players and their interests.