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Corporate Law and Corporate Governance: A Contractual Perspective

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I. INTRODUCTION

Applying basic economic analysis to the corporate form is useful for a variety of reasons. Not least among these reasons is that it provides a remarkably clear lens through which the problems of corporate law and corporate governance can be viewed with clarity and precision. In particular, economic analysis teaches that the line of demarcation between transactions that take place within firms on the one hand and transactions which take place across markets on the other hand is blurry at the best of times, and completely indistinct at other times.

The starting point for any analysis of the impact of economic thought on the problems of corporate law is Ronald Coase’s master-work, *The Nature of the Firm.*

In this article, the question of how to distinguish between markets and firms was
first presented. Much important work has been done since Coase’s piece first appeared in 1937. Now it seems clear that the role of corporate law is to reduce the costs of entering into business relationships, and the primary way in which this is done is by crafting standard-form contracts which greatly reduce the costs of organizing a business venture to the various parties, shareholders, entrepreneurs, and managers. It would be incalculably costly for the various parties to such a long-term relationship to specify all of the terms and conditions of that relationship in a single agreement, because future conditions are complex and uncertain. Because contracts are costly to write and negotiate, societies that wish to encourage capital formation, efficient capital allocation, and savings and investment will devise corporation codes which make standard-form, boilerplate language available for adoption by management and shareholders.

By providing the default language for shareholders who do not find it cost-effective to provide customized language for themselves, the law can play a powerful and salutary role. Corporate law plays a particularly large role in helping participants in the corporate enterprise deal with events that they do not believe are likely to happen. When there is a very low probability of a future contingency taking place, the costs of specifying how the parties should respond to that contingency generally will outweigh the benefits of describing the terms:

Firms that wish to avail themselves of the option can thereby lower transaction costs by not drafting and negotiating specific provisions in their contracts. But not all firms will find the legal prescription that is chosen appropriate. The ability of firms to contract around costly legal rules when lower-cost private alternatives are available must be a feature of any efficient standard-form contract.²

II. MANDATORY V. ENABLING RULES

Scholars who take the traditional, non-economic approach to corporate law and corporate governance reject the idea that corporate law rules should be enabling. These scholars assert that corporate law rules should provide a set of commands and controls which regulate the internal corporate governance of corporations and cannot be altered or deviated from by the parties, even if the parties themselves consent to such alterations or deviations.

At the outset, it should be emphasized that nobody argues that all corporate law rules should be mandatory. Even the most ardent proponents of the position that corporate law rules should be mandatory realize market forces and mutual agreement play important roles in determining the rules governing corporate behavior.³


3. Professor Melvin Eisenberg, perhaps the leading proponent of the view that corporate law should be mandatory rather than enabling, freely admits that the rules which govern corporations are determined by contracts and other agreements as well as market forces, “unilateral action of corporate organs or officials,” and law. Melvin A. Eisenberg, The Structure of Corporation Law, 89 COLUM. L. REV. 1461, 1461 (1989).

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Perhaps the most often invoked argument in favor of mandatory legal rules reflects a concern for the same agency cost problems that have interested economists. But it is in no way obvious that concern that shareholders' interests will diverge from managers' interests automatically translates into an endorsement of mandatory rules of corporate law which the parties cannot customize for their own use if they choose.

The issue is whether the benefits of a set of mandatory corporate law rules—such as the benefits that come in the form of reduced agency costs—are greater than the costs associated with those rules. All of the available evidence indicates that mandatory rules do not provide significant benefits to shareholders and that any identifiable benefits associated with such rules are greatly outweighed by the costs.4

III. THE ARGUMENTS IN FAVOR OF MANDATORY RULES

A. Investor Protection

As noted above, the principal argument in favor of mandatory rules concerns agency costs: after making their initial investments, shareholders are unable to control managers from taking unilateral actions that are contrary to shareholders' interests. Thus, it is argued, mandatory rules are needed to protect shareholders' interests. Professor Jeff Gordon has pointed out that the investor protection argument relies on two assumptions. The first assumption is that uninformed and unsophisticated shareholders "will be systematically victimized by unexpected, one-sided charter terms."5 The second critical assumption is that "charter terms, unlike other information that may affect investors' expected returns, are not priced, so that even informed investors may be victimized."6

The reason the investor protection argument depends on these assumptions is that if either of these assumptions turns out to be false, then markets will correctly price new, non-mandatory variations on corporate law that are contained in firms' charter provisions. Therefore, the initial sellers of securities, not the purchasers, will bear the costs of any sub-optimal enabling legal rules. These costs will come in the form of higher capital costs.

Both of the assumptions necessary to support the investor protection argument are deeply flawed. As Professor Gordon has observed, in sophisticated economies with robust securities markets, investors do not need to be informed to protect themselves. Securities markets are "efficient." Stock market analysts and other market participants aggregate and reflect all relevant available information concerning the firm into a single data point: the firm's share price.

As noted above, for the investor protection argument to be successful in providing a justification for mandatory terms in corporate statutes, the market must

6. Id.
somehow be incapable of pricing novel terms in corporate charters. However, this is extremely unlikely. First, unlike inside information, the information contained in corporate charters is publicly available.

A charter term that significantly affected risk or return should be noticed by the informed investor, in the same way that any other business factor would be noticed. . . Under a regime of contractual freedom, it would be astonishing if, for example, a firm junked annual election of directors in favor of a self-perpetuating board without affecting the issuance price of the next common stock offering. In other words, if mandatory provisions were eliminated, then presumably the charter would be subject to much closer scrutiny and we would readily observe price effects for significant variations from the standard form.\(^\text{7}\)

The available empirical evidence supports the conclusion that market prices adjust to reflect significant variations in charter provisions.\(^\text{8}\) For example, because of standard industry practice and long-time New York Stock Exchange rules, public corporations adhered to a policy of "one-share/one-vote." Under this policy, each share of stock issued by the company would be entitled to a vote on those issues about which voting was required. However, studies have shown that when corporations issued shares with inferior voting rights, these nonvoting or limited voting shares traded at a discount to voting shares.\(^\text{9}\) Moreover, the empirical evidence shows that the discounts in share prices for stock issued with inferior voting rights exist not only for shares issued in initial public offerings, but for shares issued in recapitalizations as well.\(^\text{10}\)

This discussion has several implications. First, market participants can readily learn of novel charter provisions and price them appropriately. In particular, there is ample evidence from the history of experimentation with special voting provisions, representation on corporate boards of directors, conversion features of debt and preferred equity, call provisions, and redemption exposure of debt that novel terms often emerge through negotiations between issuers and the underwriters who act on behalf of prospective purchasers.\(^\text{11}\) The fact that resources are expended by issuers and underwriters to specify and negotiate over novel provisions in debt instruments and in corporate charters strongly suggests that these novel provisions are priced by the market.

Second, when novel terms are injected into corporate charters or bond covenants, they are as likely to benefit investors as to harm them. Issuers, concerned

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7. \textit{Id.} at 1562.
8. \textit{Id.} at 1563.
10. See Jeffrey N. Gordon, \textit{Ties That Bond: Dual Class Common Stock and the Problems of Shareholder Choice}, 76 \textsc{Cal. L. Rev.} 1, 22-26 (1988) (discussing a 1987 SEC study on dual class recapitalizations and share prices of publicly traded companies); see also Gordon, \textit{supra} note 5, at 1563 n.47.
with minimizing the costs of raising new capital, recognize they can lower their cost of capital by agreeing to charter terms that provide greater protection to investors. Since all parties benefit when such terms are devised, both issuers and investors will readily agree to new terms that increase the overall value of a firm.

Third, a legal regime that binds participating parties through mandatory legal rules imposes costly rigidities on the legal system. Firms vary and investors' preferences vary. As a result of these variations, what is good for one firm with one set of investors may not be in the interests of a different firm with a different set of investors. Mandatory rules prohibit investors and issuers from customizing their operating environments to meet the specific needs of the relevant parties. Similarly, mandatory legal rules impede corporate law from improving through the development of innovative corporate governance structures. In a regime of corporate law that is characterized by permissive rather than mandatory rules, issuers, issuing firms, lawyers, and investment bankers all have incentives to develop new governance structures which enable firms to raise capital more cheaply by providing potential investors with the protection and assurances needed to induce them to invest at lower cost. By contrast, in a regime of corporate law characterized by mandatory rules, there are no incentives to innovate.

Even unsophisticated investors who would not ordinarily be expected to study, evaluate, and price novel provisions are protected by the market's price-setting mechanism, because these unsophisticated investors pay the market price for the securities they purchase. This market price reflects the ability of sophisticated market participants to value novel charter terms and to negotiate with issuers about how to price such terms. Thus, the argument that shareholders will be systematically victimized by unexpected, one-sided charter terms is inconsistent with the available empirical evidence as well as with the modern understanding of how capital and financial markets function. In sum, as Jensen and Meckling predicted, issuers, not shareholders, will bear the costs of uncertainty, risk and sub-optimality in novel charter provisions. They will be priced appropriately by the market, and this pricing function will serve to protect all investors, including unsophisticated investors.

In response to this discussion, it might be argued that the capital markets will succeed in pricing major events such as recapitalizations, or the issuance of non-voting shares in connection with such recapitalizations, but will not be successful in pricing remote or low probability terms, or terms which will not have a dramatic effect on shareholder wealth. Professor Jeffrey Gordon provides a complete response to this concern:

[T]here is little reason to erect and maintain a mandatory set of rules with presumably costly rigidities to avoid events whose overall expected effects are low. It would be a bad bargain. In sum, mandatory law cannot be justified on the basis of an information asymmetry between

investors and promoters.\textsuperscript{13}

B. Uncertainty

A second justification for a regime of mandatory legal rules is that without such mandatory rules, different firms will operate under different sets of rules and constraints, and these differences will cause uncertainty. In particular, uncertainty will exist concerning how a particular provision in a corporate charter will be used by the firm, or interpreted by the board of directors, or interpreted by the courts. However, as the above discussion indicates, to the extent that non-standard contractual terms increase the uncertainty surrounding the rights and obligations of issuers and investors, the costs associated with that uncertainty will be borne by the issuers, not the investors. From an economic or contractarian perspective, the costs of uncertainty will be borne by the promoters who authored the nonstandard terms. As Jeffrey Gordon observed:

\begin{quote}
Prospective shareholders will foresee the possibility of unpredictable effects on firm payouts because of the customized clauses and will insist on a lower stock price as compensation for this risk. To reduce these costs, firms will stick closely to the standard forms except where customized terms produce benefits that outweigh the costs. Two such situations are possible: where the customized term so improves the functioning of the firm that the stock price actually increases, or where the customized term provides a benefit that the promoters prize more highly than the costs. For example, control over the firm may be so important to the promoters that they opt for a self-perpetuating board, rather than annual shareholder elections, notwithstanding the discount in the firm’s share price. In both of these cases, the customized term is superior to the standard term from the perspective of private wealth maximization. Thus the uncertainty hypothesis seems to have little explanatory value for mandatory corporate law.\textsuperscript{14}
\end{quote}

C. Enabling Rules and Strategic Behavior: The Problem of Mid-Stream Corporate Changes

An important justification for mandatory rules is that such rules enable issuers to precommit to investors that they will not propose charter amendments which reduce shareholder wealth. Entrepreneurs bear the full costs of novel charter provisions when securities are first sold to the public. Such entrepreneurs have strong incentives to draft customized charter provisions that increase shareholders’ wealth by providing strong protections for investors. But after investors have parted with their money, a variety of factors conspire to make it difficult for such investors to protect their interests against “mid-stream” changes contrary to their interests.

\begin{itemize}
  \item [13.] Gordon, supra note 5, at 1564.
  \item [14.] Gordon, supra note 5, at 1566-67.
\end{itemize}
One problem facing shareholders who are confronted with such mid-stream corporate changes is that public shareholders are rationally ignorant. That is, rational individual shareholders will only invest in determining the value of a proposed charter amendment up to the point at which the costs associated with that determination are equal to or less than the benefits. This cost-benefit calculation is likely to result in rational shareholders declining to investigate the likely effects of proposed charter amendments for two reasons. First, the costs of investigating the effects of a charter provision are fixed. For a small shareholder these costs may dwarf the total value of the shareholder’s investment. For example, if the costs of evaluating a charter amendment are $100,000, it would not be rational for a shareholder with a $50,000 investment to spend the resources necessary to make that evaluation.

Second, the benefits of making an investigation must be discounted to account for the fact that charter amendments are subject to shareholder vote and that an individual shareholder’s vote is unlikely to be decisive in any particular corporate election. Thus, shareholders who investigate the likely effects of a proposed charter amendment must bear the additional costs of informing their fellow shareholders of these effects, or else the efforts allocated to conducting the investigation are not likely to be rewarded.

In addition to rational ignorance, insiders who want to enact charter amendments that reduce shareholder wealth can bundle these welfare-reducing amendments together with other unrelated proposals which shareholders favor. For example, during the mid-1980s several large American corporations proposed charter amendments that would establish a new class of common stock with voting rights superior to existing classes of stock. To obtain approval from existing shareholders, management announced plans to make large cash payouts to shareholders, either through increased dividends or share repurchases. But these dividend payouts and share repurchases were conditioned on the approval of the new class of stock by shareholders.16

Similarly, management can propose a single charter provision that imposes a so-called fair price provision, which insures that firms effectuating a statutory merger will be required to pay a certain minimum price for the shares they acquire, with a requirement that mergers receive approval from ninety percent of shareholders. The fair price provision is likely to benefit shareholders by protecting them against front-loaded, two-tier offers.18 On the other hand, the ninety percent approval requirement may hurt shareholders by making it difficult for them to accept a hostile bid that increases their wealth.

The insiders’ ability to bundle the amendments with these other proposals forces the shareholders “to take the bitter with the sweet, causing wealth reducing amendments to be adopted.”17 Thus, the spectre of mid-stream corporate changes is

17. Gordon, supra note 5, at 1577.
a problem that advocates of default rules must address. There are three responses to the problem of mid-stream changes. Once these responses are properly considered, it is impossible to avoid the conclusion that the problem of mid-stream corporate changes does not constitute a concern to a legal regime characterized by default or enabling rules.

First, it must be recognized that concern about mid-stream corporate changes is not a concern about enabling rules. It is only a concern about any legal rule that can easily be changed. If new enabling rules either cannot be changed or can only be changed with great difficulty, then the problem of mid-stream corporate changes diminishes or goes away. The reason firms do not make it difficult or impossible to make mid-stream changes to their corporate charters is that the costs of such hand-tying behavior are far greater than the benefits. The costs come in the form of making it difficult or impossible for corporations to change their internal rules of corporate governance. This rigidity is very damaging to firms that must operate in a dynamic world characterized by constant change. By contrast, the benefits of this sort of hand-tying are quite ephemeral. Shareholders are protected from the prospect of opportunistic mid-stream corporate changes from the outset, because market forces will adjust the prices they initially pay for their shares to account for the possibility that such changes will be approved.

This analysis is particularly damaging to the argument that rationally ignorant shareholders are susceptible to being opportunistically exploited through mid-stream charter amendments. Shareholders can avoid the rational ignorance problem simply by recognizing the potential problem at the time they buy their shares, and insisting on charter provisions that make it difficult for mid-stream changes to be made.

The argument that rationally ignorant shareholders will be exploited by mid-stream changes which harm shareholder interests is an additional problem. As Roberta Romano has pointed out, the argument assumes, without explanation, that shareholders always will vote “yes” for charter amendments about which they know nothing, despite the fact that such amendments may not be in their interests. This assumption makes no sense. It is at least as likely that rational shareholders will always vote “no” when such amendments are proposed if they are, in fact, rationally ignorant.18

It is also easy to over-state the costs faced by shareholders who are attempting to price charter amendments. First, shareholders recognize that any amendment which lowers the probability of a takeover occurring will be costly.19 Thus, it takes few if any resources to evaluate this sort of proposed charter alteration. Similarly, shareholders with diversified portfolios can spread the costs of analyzing a single charter amendment across all of the firms in the portfolio. This makes it less likely that diversified shareholders will elect to be rationally ignorant with respect to any given charter proposal. Finally, as the number of institutional shareholders increases, the likelihood of rational ignorance as a problem diminishes. Institutional

19. Id.
investors are likely to own large block positions in firms proposing mid-stream charter provisions, and it will be in their interests to make the investigations necessary to inform themselves about the likely effects of proposed charter amendments.\textsuperscript{20}

Second, just as the provisions that are part of a corporation’s initial charter will be properly priced from the outset, so too will the possibility that subsequent mid-stream changes to the charter will be properly priced as well. Consequently, both the issuer and the purchasing shareholders have strong incentives to make sure that \textit{ex post}, welfare reducing mid-stream changes do not occur. Thus, if mid-stream corporate changes are deemed to be a problem, the solution is not to forbid enabling rules by making corporate law mandatory. Rather, the solution is to improve the mechanism for promulgating enabling rules by allowing the contracting parties to make credible commitments that mid-stream corporate changes will not occur.

Third, as a practical matter, there is little if any evidence that shareholders have in fact ever been coerced into accepting a charter arrangement which was contrary to their interests. For example, Gordon has argued that shareholders who approve dual class stock recapitalizations have been coerced into doing so by "sweeteners" that provide them with higher dividends in exchange for their votes on the recapitalization. But, as Romano has pointed out, in these situations, insiders already had effective control of the firms pursuing the recapitalization, because on average insiders controlled forty percent of the voting stock in firms engaging in dual class recapitalizations.\textsuperscript{21} Under these conditions, the value of the voting rights to the outside shareholders is minimal, and the higher cash flow that came with the increased dividend payments in exchange for giving up illusory voting rights “is a welfare-enhancing, and not strategically coercive, transaction.”\textsuperscript{22}

Along these lines, it is important not to exaggerate the extent to which the problem of bundling enhances management’s ability to effectuate mid-stream corporate changes. As Romano observed: “[M]anagement’s ability to bundle beneficial and opportunistic proposals is limited. No doubt clever drafting of ‘add-ons’ aids management. But most proposals of charter amendments are separately placed on the agenda requiring separate votes.”\textsuperscript{23} Policymakers concerned with the possibility that shareholders will be coerced into accepting mid-stream corporate changes because of management’s ability to bundle their proposals together should not respond by advocating mandatory legal rules. Instead, they should respond by advocating a legal rule requiring that charter amendments be presented to shareholders individually and not bundled together in an omnibus package.

IV. The Arguments in Favor of Enabling Rules

As seen in the preceding Part, none of the arguments in favor of mandatory rules is persuasive. Equally important, as Roberta Romano has observed, none of the arguments in favor of mandatory rules provides a basis or criteria for deter-

\textsuperscript{20} Id.
\textsuperscript{21} Id.
\textsuperscript{22} Id.
\textsuperscript{23} Romano, \textit{supra} note 18, at 1612.
mining which mandatory rule ought to be adopted. This Part will examine the costs and benefits of structuring a system of corporate law around a system of enabling rules.

At the outset of the discussion, however, a cautionary note is in order. Those who advocate a system of corporate law and corporate governance that is enabling rather than mandatory take the view that the freedom of private agreements rather than the coercion of state-imposed rules is the "general principle" upon which corporate governance rules for top management should be built. However, those who advocate a system of corporate law based on enabling rules do not make the argument that such a system is perfect. From the standpoint of developing a rational, sound public policy, the critical inquiry is not whether a particular approach to law is perfect, but whether it is superior to the next best alternative.

In particular, those who advocate an enabling approach to corporate law recognize that writing contracts is costly. But that is not an argument against the enabling approach; it is an argument in favor of a system of corporate law which furnishes parties with boilerplate language available for adoption by the contracting parties. One of the roles of the legal system is to furnish off-the-shelf language that reduces the costs associated with writing contracts.

However, even in this context, it is easy to jump precipitously to the conclusion that the state is the only source for the off-the-shelf language, and that private institutions cannot provide standardized legal rules. In fact, private institutions are an important source of standardized legal rules, particularly in the realm of corporate law. Law firms, accounting firms, institutional investors, stock exchanges, bond rating agencies, underwriters, and a myriad of other institutions constitute sources of standardization.

A. Innovation and Mistake

The argument for enabling as opposed to mandatory rules becomes particularly strong if we start with the basic premise that we live in a complex, ever-changing world in which two assumptions clearly hold. The first assumption is that in advanced societies information is constantly being produced. The second assumption is that even the best-intentioned human beings make mistakes.

In light of these two basic assumptions, it appears clear that an advantage of enabling rules over mandatory rules is that enabling rules permit corporations to change their rules of governance to adapt to changing circumstances and new ideas. Clearly, innovation should be encouraged. Innovation is far more likely under a legal system in which corporate law is enabling than under a legal regime in which corporate law is mandatory for a variety of reasons. First, it is simply less costly for a corporate board of directors to reach agreement than for a national legislature. The board of directors has greater expertise about corporate affairs, and enjoys better access to the necessary information. Even the best intentioned legislature will have the time and inclination to focus its attention on matters of corporate law only.

24. Romano, supra note 18, at 1615.
25. McChesney, supra note 4, at 1533.
episodically.

In the United States, jurisdictional competition among states for corporate chartering revenues forces states to be responsive to technological innovations. Empirical evidence shows a significant positive correlation between a state's responsiveness to innovation in its corporation codes and the proportion of state revenues derived from incorporation (franchise) taxes. In other words, states are forced to innovate to prevent the firms that are locally chartered from migrating to other, more responsive states, particularly Delaware.

In addition, directors have incentives to adopt innovative, value-maximizing legal rules that legislators do not have. Adopting a useful new legal rule will allow a firm's managers to raise capital more cheaply. Managers who also own stock in the firms where they work have incentives to do this. Even managers who are more concerned with empire-building than with maximizing firm value have an incentive to lower the cost of raising new capital to fund their expansionist plans. Thus, managers will want to develop innovative corporate governance mechanisms that allow them to induce investors to supply capital to their firms.

Relatively recent corporate governance devices that provide event-risk protection for investors illustrate how legal innovations are made. During the late 1980s and early 1990s, a number of corporate control transactions, particularly leveraged buyouts, occurred in which bondholders suffered substantial losses. Bondholder losses were the result of the so-called "leverage effect," in which the additional layers of debt benefit the shareholders at the expense of bondholders. These shareholders, as residual claimants, enjoy huge returns on equity if their firm performs only modestly better than expected, while the fixed claimants suffer as the increased leverage dramatically increases the probability of bankruptcy for the firm. Since the bondholders, as fixed claimants, do not benefit if the firm out-performs expectations, a corporate transaction that increases firm leverage increases the default risk without a concomitant increase in the bondholders' return. Consistent with this reasoning, empirical studies have shown that bond values decline substantially in the wake of leveraged acquisition.

However, corporations are beginning to solve the problems associated with wealth transfers from bondholders to shareholders by including contractual provisions in their bond indentures that protect bondholders. These provisions, known as event-risk covenants or, more popularly, as "poison puts," provide that bondholders

27. The two best known examples are the management buyout of RJR Nabisco, in which the price of RJR Nabisco bonds dropped in value by 20% after executives announced they were considering a management buyout of the company, and the leveraged recapitalization of Colt Industries, where the value of Colt's bonds declined by 20% when management announced that $1.4 billion in equity would be replaced with debt. Kenneth N. Gilpin, Bid for RJR Nabisco Jolts Bonds, N.Y. TIMES, Oct. 21, 1987, at D11; see also George Anders, Recapitalizations Are a Bonanza for Some, But Bondholders Can Take a Terrific Beating, WALL ST. J., June 1, 1987, § 2, at 53.
have either the right to sell their bonds back to the company at a pre-determined price or the right to an automatic increase in the interest rate payable on the bonds upon the occurrence of a specified event. Not only do these covenants help reduce the agency costs associated with debt, they can also increase the overall value of the firm by lowering the costs of raising capital from fixed claimants. If experimentation were not allowed, innovations like poison puts would not be possible. Numerous examples demonstrate how mandatory rules hamper innovation. In the early stages of the development of American corporate law, courts imposed a mandatory rule, called the "vested rights" rule, that prohibited corporations from altering the rights of shareholders after their shares had been issued. Vested rights theory was used to prohibit corporations from issuing securities senior in dividend or liquidation preference to outstanding securities, to permit shareholders to convert their common stock into a new class of preferred stock carrying a seven percent dividend upon the payment of a token fee, or to reduce the dividends payable to a particular class of preferred shareholder.29 For decades, courts "repeatedly rejected attempts to alter a security's terms as an impairment of vested rights, usually without examining the fairness of the transactions."30

It is easy to see why shareholders would want to alter their own vested rights under certain conditions. For example, preferred shareholders might all agree to accept a lower dividend payout if that is the only way to avoid bankruptcy. Similarly, a firm that is on the verge of insolvency and desperately in need of new capital is unlikely to be able to raise such new capital unless it is able to offer the new investors senior securities. Under these circumstances, all shareholders might agree ex ante to offer a preference to new providers of capital. However, if an out-moded legal theory like the vested rights doctrine gives a single shareholder the ability to block a firm's ex post efforts to recapitalize, hold-up problems will inevitably occur. As Professor Coffee has observed:

This concept of vested rights thus essentially froze the corporation's capital structure and denied the corporation the flexibility to pursue new objectives or to issue new classes of securities not authorized at the moment of corporate formation. Beginning in the decade between 1910 and 1920, however, courts began to free corporate law from the strait-jacket of vested rights theory. Decisions gradually permitted the authorization and issuance of new classes of securities not in the original certificate of incorporation.31

The evolution of the so-called legal capital rules in the United States regulating the sale of stock provides still another illustration of how inflexible mandatory rules not only harm corporations by making it difficult to raise capital in times of economic difficulty, but also lead to strategic behavior by shareholders. For decades it was illegal to sell stock for less than the par value in the United States. The

30. Id.
31. Id. at 1641.
purpose of this mandatory legal rule was to protect creditors and shareholders by providing them with an indication of the price paid for shares by prior investors. Over time, however, it became clear that any marginal benefits to shareholders provided by this rule were greatly outweighed by the costs. In particular, firms were unable to sell additional stock whenever the market value of the firm’s stock dropped below the par value of the shares. Over time, a rule that was originally designed to protect creditors and shareholders became what Professor Coffee aptly described as a “legal trap for the unwary.”

When the mandatory rule requiring par value stock began to harm shareholders and firms, common law courts began to distort the law through dubious technicalities to allow firms and investors to avoid the rule. For example, in *Handley v. Stutz*, the United States Supreme Court permitted a firm to exchange $45,000 in face amount of its bonds along with stock with a total par value of $45,000 with an investor who was injecting $45,000 in cash into the firm. In this transaction:

> [T]he stock was issued at below its par value, probably as an equity “kicker” or throw-in to make the purchase of the bonds more attractive. The Supreme Court easily could have required strict adherence to the traditional rule invalidating watered stock. Yet it did not. Instead it focused on the economics of the transaction and essentially recognized that if a stock’s market value fell below its par value, the corporation would be precluded from issuing shares.

Sometime after the Supreme Court’s decision in *Handley v. Stutz*, state legislatures slowly began changing their rules to permit the issuance of stock without par value, which is now the dominant rule in the United States. Three useful implications can be drawn from this illustration about no-par stock. The first implication is that the development of capital markets and the emergence of increasingly sophisticated investors rendered the old mandatory rule obsolete. The inability to alter the rule imposed severe costs on firms in need of capital. The second implication is that common law systems can alter mandatory rules relatively easily by generating judicial opinions which ameliorate the harmful effects of mandatory rules. A final implication of this example stems from the basic fact that lawsuits like *Handley v. Stutz* were being brought against firms trying to raise capital by selling stock. The technical legal restrictions imposed by mandatory rules provided an opportunity for opportunistic shareholders to bring a lawsuit to extract a side-payment from the firm. Basic economic theory shows that as long as the new shareholders are paying the market price for the new stock being sold, existing shareholders are not being harmed by the new issuance. The only explanation for the suit is that the plaintiffs are acting opportunistically and strategically. Changing from a regime of mandatory rules to a regime of enabling rules would reduce the incidence of strategic behavior. Enabling rules would replace a system in which a

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32. Id. at 1639.
33. 138 U.S. 417 (1890).
34. Coffee, supra note 29, at 1636.
single shareholder can block a beneficial transaction with one in which a majority of shareholders can approve needed changes to corporate governance structures.

B. The Policy-Maker’s Dilemma

As suggested above, perhaps the most important advantage that the enabling approach to corporate governance enjoys over the mandatory approach is its greater flexibility in dealing with the complex decisions confronting corporate managers. A particularly intractable problem for regulators advocating a mandatory approach to corporate law is a phenomenon I have described as the “policymaker’s dilemma.” The dilemma is that mandatory rules devised by policymakers in the field of corporate governance do not benefit all shareholders in all firms. Instead, such mandatory rules simply transfer wealth from the shareholders in some firms to the shareholders in other firms. The reason the policymaker’s dilemma arises is that no system of rules for corporate governance can possibly benefit all shareholders in all firms.

Put differently, it simply is not possible for policymakers to benefit shareholders by developing rules that successfully regulate whole classes of corporate transactions. The reason for this is that every corporate governance device available to corporate decision-makers can be used either to harm shareholders or to benefit shareholders. Mandatory rules are, by their very nature, categorical. They either permit a firm to engage in a certain category of transaction, or they forbid corporations to engage in those categories.

Those who advocate enabling rules recognize that every device, scheme, transaction, or governance structure available to corporate decision-makers can be used both to hinder and to advance the interests of corporate shareholders. This duplicity applies not only to controversial and relatively complex innovations like poison pills and corporate greenmail payments, but also to venerable and seemingly benign activities, such as staggered terms for members of corporate boards of directors, dividend payments to shareholders, and the issuance of new shares of stock.

The policymaker’s dilemma can perhaps best be illustrated in the context of the takeover market, where the conflict of interest between shareholders and managers is very pronounced and well documented. The dilemma exists because every corporate governance device that might possibly be devised by management can be used either to maximize shareholder wealth, or to entrench existing management. Moreover, as the following examples will show, it is impossible to benefit investors by developing categorical rules banning or permitting corporate practices. This is because it is impossible to determine in advance whether a particular corporate action or pattern of corporate decision-making will benefit or harm shareholders.

1. Seemingly Benign Rules can be Nefarious

In every state, corporations are permitted by law to classify or stagger the

terms of members of their boards of directors. Staggering allows the election of only one-half or one-third of the board at each annual shareholders' meeting. Directors are elected for two or three year terms rather than one-year terms. Permitting staggered terms for board members has been justified on several grounds. It protects against sudden changes in management of the corporation. It allows for continuity within the board. Finally, staggered boards serve the salutary purpose of encouraging directors to develop particular knowledge about the firms they are serving by assuring directors that they will not be displaced precipitously. Even the most forceful proponents of mandatory rules of corporate governance do not advocate banning corporations from allowing directors to have staggered terms.

Despite the potential benefits, staggered boards are sometimes used by incumbent management to make unwanted takeover attempts more difficult to effectuate. In addition, staggering can reduce the impact of cumulative voting, because a greater number of votes is required to elect a director if the board is staggered than is required if the entire board were elected at each annual meeting. The point here is that one corporation might use staggered terms for directors to increase shareholder wealth, while another corporation might use staggered terms to decrease it.

Similarly, as was suggested above, a decision by a corporation to issue new shares of stock can benefit investors under some circumstances and harm them under others. When new shares are issued to raise needed capital to fund positive present value projects, all investors benefit. Sometimes new shares can only be sold if the issuing corporation either alters the rights of existing shareholders, or gives new shares priority over pre-existing shares. But when new shares are issued to benefit one investor group over another, either by diluting the investment of one group or by giving some investors a preference in bankruptcy, the issuance of new shares can harm rather than benefit the firm. Unfortunately, in the early 1900s, when the legal doctrine of vested rights prevented corporations from issuing senior securities, mandatory rules inevitably harmed shareholders by freezing the capital structure of corporations during times of economic stress—precisely when corporations most need flexibility. Corporate dividend payout practices provide yet another example of how seemingly benign corporate practices ultimately can have a harmful effect on shareholders. It is a basic tenet of corporate finance that, while a firm's capital structure may not affect the firm's cost of capital, changes in capital structure can affect the distribution of wealth among the various classes of corporate


37. Cumulative voting is a voting system designed to enhance the ability of minority shareholders to obtain representation on a corporation's board of directors. Cumulative voting accomplishes this by permitting each shareholder to cast a total number of votes equal to the number of shares owned, multiplied by the number of directors to be elected. Cumulative voting enhances the ability of minority shareholders to elect directors by allowing each shareholder to allocate all of their votes to a single director or to a small number of directors. By reducing the number of directors to be elected at each election, staggered boards of directors reduce the efficacy of cumulative voting by reducing the total votes minority shareholders are able to cast at each election.
claimants. Thus, for example, if a corporation historically has been funded with fifty percent equity and fifty percent debt, and then makes an unanticipated change in its capital structure that causes the firm to have only ten percent equity and ninety percent debt, the change will effectuate a wealth transfer from bondholders to shareholders. By increasing dividends, corporate boards of directors can transfer wealth from bondholders to shareholders by changing a corporation’s capital structure. On the other hand, corporate boards of directors also can transfer wealth in the other direction, from shareholders to bondholders, by declining to pay dividends. Judge Easterbrook has observed in an important article about corporate dividend policy:

Suppose a firm has an initial capitalization of 100, of which 50 is debt and 50 is equity. It invests 100 in a project. The firm prospers and earnings raise its holdings to 200. The creditors now have substantially more security than they started with, and correspondingly the residual claimants are paying the creditors a rate of interest unwarranted by current circumstances. They can correct the situation by paying a dividend of 50 while issuing new debt worth 50. The firm’s capital continues to be 200, but the debt-equity ratio has been restored, and the interest rate on the original debt is again appropriate to the creditors’ risk.8

Thus, depending on investors’ expectations, paying dividends can transfer wealth from bondholders to shareholders while declining to pay dividends and financing projects out of retained earnings can transfer wealth from shareholders to bondholders. It is impossible to legislate dividend policy to curb these sorts of wealth transfers, because there is no way to determine whether a particular corporate decision to pay dividends is done to transfer wealth, or to re-establish a pre-existing capital structure. Moreover, the discussion demonstrates that just as the decision to pay dividends can cause a wealth transfer, so too can a decision to decline to pay dividends.

2. Seemingly Nefarious Rules Can Be Benign

Just as seemingly benign corporate practices and policies can be used for nefarious purposes, so too can seemingly nefarious corporate actions, like paying greenmail or enacting so-called “poison pill” shareholder rights plans, actually provide substantial benefits for large classes of shareholders. Both poison pills and greenmail have been widely criticized as unsavory mechanisms through which incumbent management of public corporations can abuse corporate governance structures to hinder outside bidders’ attempts to mount successful takeovers.

Poison pills can take a variety of forms. In general, poison pills involve the distribution to existing shareholders of certain “rights” which are: (1) exercisable by the shareholders only upon the occurrence of certain defined conditions, such as the acquisition of a sizeable block of stock in the company by another firm; (2) callable

by the corporation at a nominal price whenever the board of directors so decides; and (3) discriminatory, in the sense that the rights conveyed by the poison pill are not extended to certain categories of shareholders, such as large block purchasers.

This discussion will focus on the so-called "flip-in" pill, which enables all shares of the same class other than those held by the bidder to purchase shares at a large discount on the occurrence of certain conditions, such as the acquisition of a single large block of shares. Criticism of this poison pill stems from the fact that it is an extremely effective tool for thwarting outside bidders' takeover attempts. On the other hand, the "flip-in" pill is an extremely effective tool for maximizing shareholder wealth by preventing outside bidders from acquiring control of a company too cheaply.

For example, suppose that a firm's stock is trading at $50 per share. Suppose further that management is in negotiations with a merger partner willing to pay $80 for the outstanding shares. A poison pill can be used to prevent a bidder from acquiring control of the corporation for $60 during the pending negotiations.

Similarly, the poison pill is an extremely effective device in the large publicly held corporation for preventing outside bidders from exploiting collective action problems that plague public shareholders. Suppose that a firm has 100 shares of stock outstanding, and that the market price for those shares is $50. If an outside bidder acquires effective control of the corporation by acquiring fifty-one shares for a slight premium and uses its controlling position for its own selfish benefit, the bidder can profit by obtaining control even if that control causes the overall value of the firm to decline.

The possibility that a corporation's shares can be acquired by an outside bidder in stages presents another collective action problem for target firm shareholders that poison pills can remedy. In particular, after a firm has acquired a controlling interest in another firm, the bidding firm can cause a merger between itself (or a wholly owned subsidiary) and the target firm. This merger eliminates the equity interests of the remaining shareholders in the surviving firm. This second step is commonly referred to as a "take-out merger," or a "freeze-out merger." Studies have shown that as the size of the target firms involved in takeover battles increases, two-tier bids, in which an initial bid is followed by a take-out merger, replace any-or-all bids as the most common form of tender. Even though initial bidders may not announce a second (take-out) step at the time of the initial tender offer, seventy-two percent of successful tender offers are followed by a take-out merger within five years.

Outside bidders use two-step takeover bids for a variety of reasons. Obviously, this strategy is less expensive than bidding to buy all of the stock in a target company. It is also less risky, because it allows the outside bidder to acquire control and to assess its ability to run the target company before committing the resources necessary to obtain complete control.

The outside bidder also benefits from placing the shareholders of the target

firm in a prisoner's dilemma that leads them to tender their shares. Game theorists use the term "prisoner's dilemma" to describe a situation where the inability of individuals—in this case shareholders—to coordinate their decisions leads to a suboptimal outcome from their perspective. This enables bidders to gain control of target firms at bargain basement prices. To illustrate the coordination problem:

[A]ssume a cash tender offer of $40 per share for half of the outstanding shares of a target firm where the pre-tender offer market price was $30. Further assume that if the offer fails, the target firm's stock is expected to experience a permanent upward revaluation to $37, to reflect the new information about the target's value disclosed by the tender offer. Finally, assume that the bidder has announced that the transaction will take the form of the typical two-step takeover, in which the bidder will pay cash for the first 50% of the shares tendered at the tender offer price and will either take the remainder that are tendered or engage in a takeout merger for the bidder's debt securities valued at $30 per target share. If the tender offer period is typically brief and target shareholders typically numerous, there will be no real opportunity for such shareholders to communicate with each other and to reach a collective determination of the best course of action for all. If they could reach such a decision, they would agree that rejecting the tender offer and holding target shares worth $37 would be preferable to having half or more of the shares tendered, in which case they would receive an average price of only $35.00 per share.  

The dilemma inherent in this situation is apparent. For illustrative purposes, suppose that the target firm has 101 shares outstanding, and that the bidder already owns one share. The remaining 100 shares are divided evenly between two shareholders, A and B, who are unable to communicate with each other. From A's viewpoint, the decision not to tender means that either he will retain 50 shares worth $37 each if B also decides not to tender, or that he will retain 50 shares to be taken later for $30 per share in the subsequent take out merger if B decides to tender into the initial $40 bid. Thus, by not tendering, the best that A can do is receive $37 for his shares, and the worst that A can do is receive $30 for his shares. The outcome will depend on what B does. Alternatively, if A decides to tender his shares, he will obtain $40 per share if B does not tender, but only $35 per share if B also tenders. This is a prisoner's dilemma, because A can only protect himself from the worst possible outcome and

40. This example is taken from William J. Carney, Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties, 1983 AM. B. FOUND. RES. J., 341, 350-51.

41. A receives $35.00 if B tenders because, under U.S. securities law, if a tender offer is over-subscribed, each tendering shareholder will have his shares purchased on a pro-rata basis. Thus, in this example, A and B each will have 25 shares purchased for the initial price of $40.00 and 25 shares taken in the take-out merger for $30.00. This results in a blended price to each shareholder of $35.00 per share if both tender.
have an opportunity to obtain the best possible outcome by tendering his shares at the initial bid price of $40 per share. B, of course, faces the same choices, and their separate decisions will lead to a net result of $35 per share for each of them, which is worse than the $37 they could have obtained through coordinated action. By using the poison pill, management raises the aggregate price that a successful bidder must pay to acquire control of a target firm, and eliminates the prisoner's dilemma. A target firm's board of directors can insist on a price greater than $37 per share in exchange for redeeming the outstanding poison pills. Thus, "the poison pill provides a paradigm of a novel contractual provision that can arguably be used either to maximize shareholder wealth or to entrench existing management—depending on how it is used."42

Thus, policymakers attempting to ban poison pills might benefit certain shareholders, those in firms lucky enough to receive initial bids in excess of $37, but would do so at the expense of other shareholders, who would be subject to exploitation by outside bidders. Moreover, the usefulness of poison pills is not limited to the context of two-tier bids. Poison pills will increase shareholders' wealth whenever they are used to provide corporate managers with sufficient additional time following an initial offer to permit an auction market for the firm to develop. All-or-nothing bids typically are conditioned on receiving a certain percentage of outstanding shares within a certain time-frame. This decreases the likelihood of subsequent bidders trumping the initial offer. Under such circumstances, poison pills are a useful device for obtaining a delay to see if better offers develop.

The above analysis applies not only to poison pills but to all defensive tactics. All defensive tactics mitigate the effect of the prisoner's dilemma facing target shareholders and raise the aggregate price that a successful bidder must pay for target shareholders' stock. Of course, defensive tactics are not without cost. In particular, there is almost always the danger that the defensive tactics will substantially raise the cost of an outside acquisition, so that no bids are made for the target. An important exception to this general rule is the payment of corporate greenmail, perhaps the most widely excoriated of all defensive tactics.

Greenmail lowers bidders' costs because of two important, albeit frequently ignored, features of greenmail payments. First, unlike the transfers of wealth associated with other defensive tactics such as poison pills, outside bidders receive greenmail payments directly. Thus, greenmail payments represent a source of additional profits to an outside bidder rather than a source of potential loss. Second, an outside bidder can decide for himself whether to accept a greenmail payment, and thus can decline to accept a greenmail payment that does not provide sufficient compensation.

Thus, from the perspective of target firm shareholders, greenmail is different from all other defensive tactics, because it does not pose the risk that bidders will find the cost of takeover too high and decline to make a bid in the first place. Moreover, the prospect of greenmail improves corporate performance by raising the overall level of monitoring of potential target firms by outside bidders:

42. Coffee, supra note 29, at 1653.
Thus the payment of greenmail where there is a realistic threat of a takeover allows target shareholders to “have their cake and eat it too.” Greenmail allows the firm to make unwanted suitors go away without discouraging them from producing information about the target firm in the first place. And, unlike other defensive tactics such as shark repellent amendments, greenmail does not discourage additional tender offerors from making offers, but rather encourages them. The ability to pay greenmail thus increases the probability of a takeover attempt occurring while other defensive tactics lower it.48

3. Concluding Observations

This discussion of greenmail suggests that there is another aspect of the policymaker’s dilemma that further suggests the superiority of enabling rules over mandatory rules. The first aspect of the policymaker’s dilemma which provides support for a system of enabling rules lies in the fact that every contractual provision or governance device in the corporate world can be used either to maximize shareholder wealth, or to transfer wealth from shareholders and other investors to other groups. Consequently, it simply is not possible for even the most benign and well-meaning central planner to devise mandatory rules that benefit all shareholders. Only a system of enabling rules, which permits firms to customize their own internal rules of corporate governance to meet the particularized, individual needs of their investors, can serve the goals of public policy.

The analysis of corporate greenmail presented here has additional implications for policy analysis. First, it suggests that even within single firms rigid rules may be inappropriate. It may be in the shareholders’ interests that greenmail be paid to fend off one outside bidder, but not another. Flexibility is important. Second, the limits of human understanding are such that corporate practices which may appear to policymakers to be contrary to shareholders’ interests may, in fact, benefit shareholders.

Consistent with the view that corporate law should serve as a standard form contract, the emphasis of this discussion is not to argue that corporate law should endorse the payment of corporate greenmail. The point is that a legal system of mandatory rules which apply to all firms and all situations cannot provide the customization needed. Thus, while standard-form contracts serve a valuable purpose in lowering transaction costs, which maximizes shareholder wealth, firms must be allowed to alter the standard-form rules to meet the particular needs of their investors.

C. The Economic Theory of Regulation

Until now, the discussion of the relative desirability of mandatory rules versus enabling rules has presumed that policymakers have access to the same set of regu-

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43. Macey & McChesney, supra note 39, at 26.
lations, and have the same set of incentives as shareholders and other investors. But this is not the case. The economic theory of regulation has shown that politicians are likely to make politically motivated decisions rather than economically motivated decisions:

The economic theory of regulation applies to the legislative process by which legal rules that govern the affairs of corporations are made. Shareholders are a diffuse and poorly organized pressure group; management, by contrast, is concentrated and well organized, and thus is more likely to carry the day politically. One therefore predicts, and in fact finds, that shareholders cannot count on the legislature to do what is best for them. The prevalence of state antitakeover statutes, for example, demonstrates how the law—using mandatory rules around which shareholders may not be able to contract—can be used to benefit management (and labor) at the expense of shareholders in the firm.  

The overwhelming theoretical and empirical support for the economic theory of regulation provides a significant obstacle to those who criticize the enabling approach to corporate law. Managers, directors, and controlling shareholders are subject to a variety of market constraints that limit their ability to act selfishly. For this reason alone, private ordering seems desirable. While managers and directors seldom own controlling interests in the firms for which they work, top managers often have a significant portion of their personal wealth invested in their firms. Moreover, the income they receive can be viewed as an annuity. This annuity virtually always represents the largest single source of wealth for corporate managers. Thus, there is no reason to believe that politicians and bureaucrats are any more benign, selfless, and impartial than the corporate managers, directors, and controlling shareholders whose authority would be displaced in a legal regime governed by mandatory rules. For these reasons, it is not surprising that experienced observers of corporate behavior, such as Professor Eisenberg, have noted that managerial conscience is generally consistent with shareholders' interests.  

In addition, managers, directors, and controlling shareholders inevitably will have better information about the corporation than politicians and bureaucrats. Corporate managers are experts. They have localized knowledge of the particular needs and unique conditions that affect their firms. Even the most benign politicians and bureaucrats lack this sort of expertise and information.

The validity of the economic theory of regulation requires those who favor mandatory rules not only to find flaws in the enabling approach, but also to show that the government regulations involved in a mandatory system of corporate law

44. McChesney, supra note 4, at 1544 (citing Jonathan R. Macey, State Anti-Takeover Legislation and the National Economy, 1988 Wis. L. Rev. 467, 469-71; Roberta Romano, The Political Economy of Takeover Statutes, 73 Va. L. Rev. 111, 145-87 (1987)).
offer a superior alternative. To put the matter differently, neither those who favor a contractual approach to corporate law or those who favor a mandatory approach can demonstrate that their approach solves all of the problems facing investors and managers in public corporations. To prevail in the relevant policy debate, one side should show that it is better than the alternative approach.

At this point, one might well ask why shareholders are more successful at protecting their own interests and investments within the corporation than within the legislature. The evidence from the recent wave of state anti-takeover legislation within the United States strongly suggests that managers believe that lobbying the legislature is a surer or cheaper means of obtaining protection than risking a shareholder vote. One reason for this is that the negative effects on shareholder wealth which are caused by enacting rules contrary to shareholders' interests are immediately observable when those rules are enacted at the firm level. However, when such rules are enacted at the state or national level, and affect large numbers of firms simultaneously, the wealth effect on individual firms is far harder to discern.

Shareholders are better able to protect their own interests at the firm level than in the legislative arena. Free rider problems that prevent shareholders from galvanizing into an effective political coalition at the national level are greatly reduced at the firm level. The economic theory of regulation predicts that laws are likely to benefit the few at the expense of the many, because no one has an incentive to enact laws which benefit the people in general. This is the classic "free-rider" problem that inevitably plagues public interest legislation in a representative democracy. Because the benefits of public-interest legislation are spread among everyone in the population, individual members of the public lack sufficient incentives to promote public interest laws since all the costs of such promotion must be absorbed by the promoters themselves. It is extremely unlikely that any individual will find it advantageous to devote privately the necessary resources needed to obtain legislation that is in the interests of all shareholders in all corporations. The investment will involve obtaining the necessary information to know what is in the interests of all shareholders in all corporations, as well as the resources necessary to communicate that information in a coherent fashion within national policy circles. Since any gains from this investment go to every shareholder in the society, those who contribute nothing benefit just as much as those who have contributed a great deal. Thus, it pays for each individual to do nothing and to hope that others will make the necessary efforts. This is the essence of the "free rider" problem.

Members of small groups can overcome the free rider problem more easily than members of large groups. For one thing, as groups become smaller, individuals will be able to capture a greater share of any gains associated with making marginal improvements in governance structures. In addition, as Richard Posner has observed, "the fewer the prospective beneficiaries of a regulation, the easier it will be for them to coordinate their efforts to obtain regulation."}

In summary, the implication of the economic theory of regulation for the mandatory/enabling debate is that, if all else is equal, the authority to make decisions that affect corporations ought to be delegated to the decision-maker whose incentives are most closely aligned with the interests of shareholders and other investors. While managers' incentives may diverge from the incentives of investors, over a wide range of issues their interests coincide closely. Additionally, a variety of forces bring those interests even more closely into alignment. These market forces include competition in the capital market, competition in the internal and external managerial labor markets, competition in the products markets, and incentive-based managerial compensation contracts.

D. The Empirical Evidence

Ultimately, the best way of evaluating the relative desirability of an enabling regime of corporate law, as opposed to a mandatory regime, is by examining the relevant empirical evidence. Neither alternative is perfect. Theoretical claims of superiority for one system over another can always be made in the absence of empirical evidence. Because corporate law is generally a matter of state law, the variety of laws in the fifty states provides a useful natural laboratory for testing the relative advantages of alternative legal regimes.

The most striking thing about the jurisdictional competition for corporate charters is that "[w]ithin the federal structure, one state, Delaware, which is a small state by any measure—population, geography, industrial or agricultural production—has dominated all the rest."49 Since the early 1920s, Delaware has been winning the jurisdictional competition for corporate charters on any measure. Approximately one-half of the largest industrial firms in the United States are incorporated in Delaware,50 and about forty percent of corporations that are listed on organized stock exchanges in the United States are chartered in Delaware.51

Several aspects of Delaware's dominance of the jurisdictional competition for corporate charters are relevant to this discussion. Delaware is the state with the most flexible and adaptable corporate code. Delaware corporate law is almost completely enabling. For example, Delaware corporate law permits the certificate of incorporation to contain a provision:

[E]liminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a (i) director for any breach of the director's duty of loyalty to the corporation or its stockholders.52

335, 345 (1974).
49. Romano, supra note 47, at 1.
50. Romano, supra note 26, at 261 n.49.
Similarly, Delaware corporations have the power to issue "[s]hares of stock without par value . . . for such consideration, as is determined from time to time by the board of directors."\(^{53}\) And, finally, the general restrictions on business combinations with interested directors can be waived if the shareholders approve.\(^{54}\)

The great flexibility of Delaware law must be interpreted in light of empirical studies of the effects of reincorporation by corporations from other states to Delaware on shareholder wealth. These studies uniformly have found that shareholders benefit when their firms change their situs of incorporation to Delaware. These empirical studies, conducted over a period of years by a variety of financial economists, use an accepted econometric technique called the event study to measure the effect of specific unexpected events on a firm's share prices.\(^{55}\) When firms announce their intention to relocate to Delaware, share prices go up.

Delaware is not only the state with the most flexible corporate law, it is also the state whose corporate law is the most responsive to outside innovations.\(^{56}\) Studies have shown that Delaware often invents new corporate law rules to respond to changing circumstances. Even when Delaware does not invent a new code provision, it is the first to imitate the code provisions invented by other states. This provides further support for the fact that the best corporate law is the corporate law that is flexible and responsive to change. There is no question that enabling rules are more flexible and responsive than mandatory rules.

Examining what corporations actually do when applicable corporate law rules permit flexibility provides another source of empirical support for the enabling approach to corporate law. For example, as mentioned earlier, corporate greenmail payments have been widely attacked as being harmful to shareholders. Those favoring a mandatory approach to corporate law have advocated that greenmail payments be banned outright.

Four major econometric studies of the effects of greenmail payments on shareholder wealth have produced interesting results. These studies analyze the entire greenmail process to determine the net effect on shareholders' wealth from the time the greenmailer makes his initial purchase of stock in the target firm to the time the greenmail payment is actually made.\(^{57}\)

Three of these studies found the overall effects of the greenmail process on shareholder wealth to be statistically significant and positive. That is to say, when a greenmailer makes his initial purchase of stock in the target firm, there is a large, positive effect on share prices. Later, when the greenmail is paid, there is a smaller, negative effect on share prices. On average, the net effect of the entire greenmail process is positive. As the authors of one study concluded, "it is striking that when

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\(^{53}\) DEL. CODE ANN. tit. 8, § 153(b) (1992).


\(^{55}\) Allen Hyman, The Delaware Controversy—The Legal Debate, 4 Del. J. Corp. L. 368 (1979);

\(^{56}\) Romano, supra note 26, at 280.

\(^{57}\) See Macey & McChesney, supra note 39, at 44-48 (extensively discussing studies by Mikkelson & Ruback, Holderness & Sheehan, Poulsen, and Jarrell & Ryngaert).
the final outcome of an investment is a standstill agreement with the target firm, the total return earned by target shareholders is positive, even though the price effect of the standstill or repurchase announcement is negative."²⁸ Indeed, even if we ignore the positive share price effects of the greenmailers' initial purchases, in 44% of the cases studied the payment of greenmail alone was associated with a positive change in shareholder return. Thus, banning greenmail payments would result in a diminution of shareholder wealth for many, perhaps most, firms.

The only study of the greenmail process concluding that greenmail is harmful to shareholders was the Jarrell and Ryngaert study. Their study is methodologically flawed in ways the other three studies were not. Consistent with the other studies, Jarrell and Ryngaert found that the initial purchases by the greenmailer caused a 9.7% increase in the share price of the target firm. Like the other studies, Jarrell and Ryngaert found that when the greenmail was actually paid, the decline in share price of 5.2% was smaller than the initial increase. However, unlike the other studies, Jarrell and Ryngaert conclude that greenmail leaves repurchasing firms worse off because of events in the "interim period" between the time of the initial purchase and the time of the greenmail payment.²⁹ The average interim period in the Jarrell and Ryngaert study was 280 trading days—well over a full year. Serious methodological problems arise in extending the study period for this length of time. In particular, it seems clear that study results were clouded by other events entirely unrelated to the initial purchase and greenmail payments themselves, because the distortion to empirical results created by random noise increases with the length of the period being treated as a single event.

For purposes of this discussion, the critical point is that the empirical studies report only averages. Greenmail benefitted shareholders in some firms and harmed shareholders in others. It is simply not possible for regulators to determine which firms would benefit from paying greenmail and which would be harmed by such payments. Moreover, for any target firm, it might make sense to pay greenmail in some circumstances, and to decline to pay in others. Only an enabling approach to corporate law allows this kind of flexibility. Consistent with this theory, it is instructive that many firms have enacted charter provisions specifically banning management and directors from paying greenmail, while other firms continue to permit the practice. This is an example of the enabling process at work.

Another example of the enabling process at work involves the decision by many state legislatures, including Delaware, to permit corporate boards of directors to "opt-out" of personal liability for directors for violations of the fiduciary duty of care. The justification for making legal liability provisions enabling rather than mandatory stems from the fact that the prospect of legal liability for corporate officers and directors has costs as well as benefits for corporate shareholders. Legal liability benefits shareholders to the extent that the potential for legal liability forces managers and directors to work harder to maximize value for shareholders.

Legal liability imposes costs on shareholders for a variety of reasons. First, the

²⁸. Id. at 45 n.107.
²⁹. Id. at 45.
potential for legal liability may make managers and directors too risk averse. This risk aversion can deter corporations from making profitable investments because managers and directors are concerned that if the investments turn out badly, they will be subjected to personal liability. As Ralph Winter, a prominent federal judge and former Yale Law School Professor has observed:

[P]otential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions. Some opportunities offer great profits at the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit. Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others.60

Another cost of open-ended personal liability for managers and directors for negligence is that it imposes needless administrative costs on the corporations. Administrative costs arise because officers and directors are concerned about shareholder lawsuits. They attempt to insulate themselves from personal liability by hiring lawyers and investment bankers whenever important corporate decisions are being made to create a paper record that provides a contemporaneous justification for their decisions.

Finally, rational shareholders might elect to abandon their right to bring suits against directors for negligent acts, because of the costs imposed by imperfections in the litigation process. First, the litigation process is widely understood to be:

[A] most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.61

A second reason for doubting the efficacy of the litigation process is that the widely disbursed shareholders in a public corporation have no incentive to incur the high costs of bringing a lawsuit against the directors of the firms in which they own shares. Usually the costs of bringing the lawsuit are greatly in excess of any individual shareholder's pro-rata share of the gains. The legal system has responded to this difficulty by permitting class-action and derivative lawsuits to be brought against corporate directors. These lawsuits substitute lawyers for shareholders as the real parties in interest in the suit.

Unfortunately, solving the collective action problem among shareholders often

61. Id.
creates an even greater problem. Costly litigation may be brought against corporate
directors not because of the benefits to the corporation of bringing such litigation,
but rather because of the attorneys' counsel fees involved in negotiating a settle-
ment. Firms settle even non-meritorious lawsuits when the costs of continuing the
litigation are greater than the costs of settlement. Thus, rational shareholders will
often conclude that the savings associated with "opting-out" of this costly litigation
process greatly exceed the costs of denying themselves the rights afforded by the
system.

V. CONCLUSION

The preceding discussion has provided an exposition of the perspectives to be
gained from an economic approach to corporate law. The point of this discussion has
been to show that investors, capital markets, and society generally will be better off
if policymakers take an enabling approach to corporate law. Under this approach,
the corporate form can continue to serve its traditional role as a remarkably
powerful device for financing complex, capital-intensive business ventures in
advanced societies that enjoy reasonably broad distributions of wealth. An enabling
regime of corporate law provides a useful set of off-the-rack rules so that partici-
pants in corporate ventures can economize on contracting costs. The ability of an
enabling system of corporate law to deal with change gives such systems distinct
advantages over rigid, mandatory rules. This flexibility is particularly important in
canon law countries, where legal change is less frequent, than in common law coun-
tries, where legal change occurs with every judicial decision.