

THE FRAUD-ON-THE-MARKET THEORY REVISITED

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INTRODUCTION

IN his interesting and provocative essay, “Back to *Basics*: Regulating How Corporations Speak to the Market,”¹ Ian Ayres criticizes our recent article dealing with the so-called “fraud-on-the-market” theory.² We, in turn, have some criticisms of his criticism, which we present in this brief Essay. At the outset, however, we wish to emphasize that, despite the rather adversarial tone of Professor Ayres’s article, he does not appear to disagree with either of the principal arguments we presented. First, Professor Ayres’s fine article clearly shows that he agrees with our proposition that contractual rules should dictate the nature and extent of a corporation’s public disclosure obligation.³ Indeed, we argued that the precise contours of the corporate disclosure obligation should be defined by the contractual fiduciary duties of care and loyalty managers and officers owe their shareholders.⁴ Second, and perhaps more interestingly, Professor Ayres agrees with our more controversial argument that firms should have the option of selecting an internal rule of corporate disclosure permitting them to make false statements in order to protect the value of corporate investments against ruination from premature disclosure.⁵

Much of Professor Ayres’s disagreement with us stems from two sources. First, he appears to believe that we were arguing in favor of some sort of bizarre “mandatory” rule of corporate law that would enable managers to make false statements about anything at anytime

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¹ Ayres, Back to *Basics*: Regulating How Corporations Speak to the Market, 77 Va. L. Rev. 945 (1991).

² Macey & Miller, Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory, 42 Stan. L. Rev. 1059 (1990).

³ See Ayres, *supra* note 1, at 950.

⁴ Macey & Miller, *supra* note 2, at 1067-68.

⁵ See Ayres, *supra* note 1, at 963.

without fear of legal liability.⁶ Not only is this incorrect, but we cannot even imagine such a legal regime. In fact, in our view, managers should engage in misdirection only when doing so is consistent with their fiduciary duties of care and loyalty to their shareholders.⁷ Taken together, these fiduciary duties represent a meta-corporate contract obligating corporate management to maximize shareholder wealth.

The second area of disagreement between ourselves and Professor Ayres relates to our conflicting predictions about the corporate disclosure obligation likely to result under the legal regime of free contracting that he endorses, as do we. Here we emphasize that the important policy question is whether this issue is something about which firms and shareholders should be permitted to contract. The particular sort of agreement that will emerge as the dominant form is an empirical question that is purely academic; nothing turns on it from a policy perspective.⁸

As Professor Ayres observes, we predicted in our recent article, for reasons we presented at some length, that both managers and shareholders would find it in their interests to reserve the right occasionally to make false statements in order to preserve the value of corporate investments.⁹ We argued that *Basic Inc. v. Levinson*¹⁰ presented a situation in which rational, fully informed shareholders likely would have agreed ex ante to permit their managers to engage in misrepresentations.¹¹ In the absence of an express agreement covering the issue, courts face the question of how to interpret the terms of the implicit contract between managers and their shareholders. We argued that any judicial formulation of a corporate disclosure obligation should conform to the fiduciary duties that form the basic framework of the corporate contract.¹² In particular, fully informed

⁶ See *id.* at 14.

⁷ See Macey & Miller, *supra* note 2, at 1076.

⁸ See generally *id.* at 1068-69 (discussing "hypothetical bargain" approach). Where a particular corporate contract is silent about whether managers can ever make misrepresentations, however, courts may look to the actual contractual provisions adopted by other firms for guidance as to the appropriate default rule.

⁹ See Ayres, *supra* note 1, at 959.

¹⁰ 485 U.S. 224 (1988).

¹¹ See Macey & Miller, *supra* note 2, at 1069-70, 1072.

¹² See *id.* at 1067-68.

shareholders negotiating *ex ante* likely would select a rule of corporate disclosure that maximized aggregate shareholder wealth.¹³

Professor Ayres does not address the issue of shareholder wealth-maximization in his article; therefore, knowing whether he thinks that firms would adopt the legal regime he advocates because of its wealth-maximization characteristics or for some other reason, perhaps a redistributive one, becomes difficult. Moreover, as we discuss below, the precise contours of his legal regime seem a bit obscure. At times, he apparently predicts that firms will opt for a rule that would forbid managerial falsehoods; at other times, he assumes that firms will opt for a rule that permits managers to engage in misrepresentations, as long as they inform the market that they may be doing so.

Part I of this Essay elaborates on the areas of disagreement between Professor Ayres and ourselves on the issue of corporate disclosure. In Part II, we make some brief observations about his views of market efficiency. In conclusion, we find his critique unpersuasive and adhere to our view that corporations should have the option of engaging in misdirection when necessary to maximize shareholder wealth.

I. THE CORPORATE DISCLOSURE OBLIGATION

A. *The Corporate Agency Contract and Shareholder Preferences*

Professor Ayres correctly observes our argument that corporate fraud should be defined by contractually defined fiduciary duties.¹⁴ After making this observation, however, Professor Ayres accuses us of overlooking “the implications of being able to contract around any standard-form fiduciary duty.”¹⁵ We must confess to a certain confusion on this point. In our understanding, corporate law rules come in two basic varieties: mandatory legal rules around which parties cannot contract and contractual rules. By definition, parties may contract around legal rules that are contractual in nature.

Mysteriously, Professor Ayres, having correctly understood our argument that corporate fraud should be defined in contractual terms, then accuses us of failing to appreciate the implications of an ability to contract around unwanted contractual terms. Of course, we think that the parties should be able to specify by contract the precise

¹³ See *id.* at 1072.

¹⁴ Ayres, *supra* note 1, at 948.

¹⁵ *Id.* at 948.

nature of the corporation's disclosure obligations. To say, as we do, that a rule is contractual in nature is, at least to us, the same as saying that one may contract around the rule. Otherwise, our argument would become that corporate fraud rules should be treated as mandatory, rather than contractual, in nature. Professor Ayres, therefore, wrongly accuses us of failing to appreciate the default nature of the corporate disclosure obligation.

Because we clearly contemplated that corporate disclosure obligations would represent default rules, the possibility of contracting around our legal rule does not change our public policy analysis. In a nutshell, we argue that, from an *ex ante* perspective, shareholders will, at times, want their managers to engage in misrepresentations because doing so will benefit shareholders generally.¹⁶ Thus, our intuition, which appears to us rather uncontroversial, is that shareholders will opt for the contractual rule that maximizes their wealth.¹⁷ Because of our assumption that shareholders will opt for the disclosure rule that allows them to maximize their wealth *ex ante*, nowhere in our analysis does an immutable rule in this regard fit.

Professor Ayres's assertion that "shareholders at a minimum should have the option of 'warranting' the honesty of their managers' speech in the articles of incorporation,"¹⁸ though true, is not particularly informative. It is uninformative for the same reason that it is true: shareholders should have the option, within public policy limits, to do whatever they want *ex ante*—including altering the basic meta-rule that puts profit maximization above all else. The interesting question is not whether shareholders should have the ability to opt out of a default provision; they have this option in every such context by definition. The interesting question is: Which rule of corporate disclosure will rational, profit-maximizing shareholders likely select? We assume that Professor Ayres would agree that, in the absence of a specific agreement to the contrary by shareholders, courts should adopt the legal standard that maximizes shareholder wealth.

Next, Professor Ayres asserts that most shareholders would prefer a default rule under which managers are assumed to warrant the honesty of corporate speech by impliedly promising to pay damages if

¹⁶ Macey & Miller, *supra* note 2, at 1072.

¹⁷ See *supra* text accompanying note 13.

¹⁸ Ayres, *supra* note 1, at 949-50.

they engage in misrepresentations.¹⁹ Unfortunately, Professor Ayres does not substantiate this assertion except by saying that only by making such promises “could corporations keep the market from severely discounting their managers’ statements.”²⁰ Of course, no evidence exists that the market does not severely discount the statements of corporate managers, anyway. Indeed, as Professor Ayres admits, even before the advent of federal securities laws, firms attempted to make their statements to the market credible by hiring independent accountants to verify them.²¹ And, as he appears to recognize, “[s]hareholders might prefer, at times, that their managers talk about the corporation’s future prospects without the specter of securities fraud liability if the prediction does not come to pass.”²²

Professor Ayres’s article thus contains its own refutation. Shareholders likely will not prefer a default rule that commits managers to honesty if superior, low-cost substitute mechanisms for managerial truthfulness, such as independent accountants, lawyers, and investment bankers, exist. These means of warranting corporate speech cost less than the managerial warranty of honesty he advocates because his warranty default would likely have a chilling effect on managerial speech.

When we add to the above analysis the additional problem, which Professor Ayres also appears to recognize,²³ that his warranty policy carries with it the specter of inefficient or opportunistic lawsuits, his article appears to endorse, rather than to criticize, our position. Indeed, Professor Ayres’s piece contains some justifications for eliminating managerial liability for false statements that we had not considered.

In sum, our analysis proceeds along the following lines. First, we assume the contractual nature of the basic fiduciary duties of care and loyalty that corporate officers and directors owe to shareholders. These fiduciary duties represent default rules because they fill certain “gaps” that inevitably arise in contractual agreements between shareholders and the firms in which they invest. Second, to fill these gaps,

¹⁹ *Id.* at 952 (“it is difficult to argue that the majority of shareholders would not prefer a default that warranted honesty.”).

²⁰ *Id.*

²¹ *Id.*

²² *Id.* at 954.

²³ *Id.* at 955.

a "meta-rule" must exist to guide the judge who is called upon to perform such gap-filling in the event of litigation. In the context of corporate law, the usual meta-rule is one of shareholder wealth-maximization. The basis of our analysis is the simple assumption that shareholders will opt for the (default) legal rule that maximizes their wealth.

B. *The Wealth-Maximizing Misrepresentation*

Professor Ayres argues that it is better to say "no comment" in response to certain questions than to make a false statement. We have several reactions to this. First, we do not argue, hint, or suggest that managers should make misrepresentations as a general rule. Indeed, we emphasized that deception often involves costs and should not be permitted except in rather unusual circumstances,²⁴ such as those presented in *Basic Inc. v. Levinson*.²⁵ Finally, although generally it will be best for managers to tell the truth, Professor Ayres's endorsement of the generally accepted "no comment" approach would do nothing to solve the very real problem that confronted the officers and directors of Basic as it tried to protect the confidentiality of its merger negotiations with Consolidated Engineering.

As is common in large, publicly held corporations, stock watchers and financial analysts often asked the officers and directors of Basic if it were involved in merger negotiations.²⁶ For a long time, the officers and directors of Basic could truthfully respond in the negative.²⁷ If, after having denied that they were involved in merger negotiations, Basic's officers and directors had suddenly changed their response to "no comment," the "no comment" would have amounted to an admission that merger discussions were underway. The Supreme Court virtually acknowledged as much in *Basic*, but concluded that "creating an exception to a regulatory scheme founded on a prodisclosure legislative philosophy, because complying with the regulation might be 'bad for business,' is a role for Congress, not this Court."²⁸

²⁴ These circumstances are limited to those "where [strategic misrepresentations are] necessary to protect existing investments or legitimate corporate opportunities." Macey & Miller, *supra* note 2, at 1076.

²⁵ 485 U.S. 224 (1988).

²⁶ *Id.* at 227 n.4.

²⁷ *Id.* at 226-27.

²⁸ *Id.* at 240 n.17.

Thus, the Supreme Court acknowledged that the rule it adopted in *Basic* may reduce shareholder welfare in some situations, but concluded that it lacked the authority to modify a validly enacted statute on the ground that it disagrees with it. Professor Ayres has no such excuse. He argues that firms should precommit never to respond to questions such as those regarding mergers.²⁹ This proposed policy will hardly advance the policy goal of dissemination of information. Although our endorsement of misrepresentation in limited contexts may contravene the policy goal of ensuring honesty in the marketplace, one must not overlook, as Professor Ayres does, that corporate disclosure rules, like all legal rules that attempt to enhance the efficiency of the market, are instrumental rules; they are not ends in themselves.³⁰ In particular, these rules are meant to enhance investor welfare.³¹ Whenever a disclosure rule conflicts with the enhancement of investor wealth—the fundamental goal of the securities laws—the wealth-maximization rule should predominate, absent an unequivocal indication to the contrary from shareholders.³² Consequently, Professor Ayres advocates a rule without redeeming virtue, in that it would not only reduce shareholder welfare in certain circumstances (as in *Basic* itself) but would also impair the flow of information to the market. In stark contrast, our proposal serves an overriding goal, grounded in congressional intent—maximizing shareholder value.

We think that the disagreement between Professor Ayres and ourselves stems from the fact that Ayres fails to appreciate the problem that rumors present to corporate management. Corporate managers cannot respond adequately to rumors simply by saying “no comment.”³³ Protecting a firm’s legitimate property rights or expectations often requires stronger statements, or misrepresentations.³⁴ As noted above, *Basic* itself provides an example of such a situation; *SEC v. Texas Gulf Sulphur Co.*³⁵ provides an even more powerful example.

Texas Gulf Sulphur (TGS), after extensive exploration in eastern Canada, discovered huge deposits of copper, zinc, and silver near

²⁹ See Ayres, *supra* note 1, at 957-59.

³⁰ Macey & Miller, *supra* note 2, at 1073-74.

³¹ *Id.*

³² *Id.* at 1074.

³³ *Id.* at 1073.

³⁴ *Id.* at 1091.

³⁵ 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

Timmins, Ontario.³⁶ Having found that the land they were exploring contained extensive mineral deposits, TGS faced the problem of not owning the land.³⁷ Obtaining the mineral rights to the land before the landowners learned of the mineral deposits became acutely important to TGS in order to maximize the gains from its search and exploration operations; otherwise, transfer to the landowners, without compensation to TGS, of all of the gains from TGS's search efforts would result.³⁸ Thus, secrecy acquired paramount importance in this transaction.

Professor Ayres suggests that TGS should have committed itself ex ante to a policy of saying "no comment" to all such inquiries where secrecy is desirable.³⁹ Barring that, he argues that the firm should have committed to telling the truth, reserving the option to decline to warrant the truthfulness of certain statements.⁴⁰ By contrast, to us it seems quite clear that TGS's managers should have been able to deny falsely rumors of its important discovery, until it had succeeded in securing the mineral rights to the land.

Bluntly stated, we believe the wrongdoers in situations such as *Basic* and *Texas Gulf Sulphur* are the people asking the questions, not the people telling the falsehoods. The people who asked the questions about the pendency of merger negotiations in *Basic* and about the mineral exploration in *Texas Gulf Sulphur* tried to expropriate the value of certain investments made by these companies.⁴¹ Allowing these potential free riders to obtain the valuable information developed by the corporations at great expense would discourage similar investment in information. Such discouragement would decrease the amount of corporate development in areas of mineral discoveries or synergistic mergers.

Despite the virtues of misrepresentation in these narrow contexts, we recognized that at least two potential problems exist with any legal rule that condones false statements by corporate fiduciaries. First, the

³⁶ *Id.* at 843.

³⁷ Macey & Miller, *supra* note 2, at 1071.

³⁸ *Id.*

³⁹ See Ayres, *supra* note 1, at 957-59.

⁴⁰ See *id.* at 953-54.

⁴¹ In *Basic*, the investment came in the form of the time and energy spent by both the bidder and the target in negotiating a merger, and in *Texas Gulf Sulphur*, the investment came in the form of resources devoted to mineral exploration.

untruthful firm does not internalize all of the costs associated with such misstatements.⁴² Second, corporate management may falsely state its position not to enhance shareholder welfare, but to benefit itself.⁴³ We noted that these problems become less acute when, as in *Basic* and *Texas Gulf Sulphur*, the corporate misrepresentations cause the price of the firm's shares to trade at artificially low levels, for two reasons, both of which ensure that managers will make misrepresentations only for shareholder wealth-maximization purposes.⁴⁴

False statements that cause a firm's share prices to trade at artificially low levels make corporate financing more difficult by causing the market to reduce its estimates of the firm's future income stream.⁴⁵ Professor Ayres responds by asserting that misrepresentations cannot increase a firm's cost of capital if the firm need not borrow from the external capital markets.⁴⁶ On this point, he is almost correct. He is correct that if a firm obtains no external financing, the market's assessment of its future income stream will not be relevant to its cost of capital. He holds an impoverished view of what constitutes external financing, however. He seems to think that firms resort to external capital markets only when they engage in investments. This is incorrect. Virtually all firms are constantly in the market for external funds. For example, they finance inventories, they issue commercial paper, they purchase merchandise on credit from suppliers. When employees receive payment for work they have already done, they have, in a very real sense, extended credit to their firms. Given the expansive nature of external financing, we challenge Professor Ayres to find a firm that does not utilize it.

His observation that sixty to eighty percent of all corporate investment comes from internally generated cash does not mean that twenty to forty percent of firms do not attempt to obtain external financing. First, some of these firms would like to obtain external financing but cannot. More importantly, almost all of these firms finance themselves through a combination of external and internal financing. The willingness of outsiders—whether they are customers, suppliers, investors, or banks—to lend to a corporation will depend on the firm's

⁴² See Macey & Miller, *supra* note 2, at 1075.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ Ayres, *supra* note 1, at 959-61.

creditworthiness. The firm's creditworthiness, in turn, will depend on the market's assessment of the firm's expected future cash flows. Where corporate misrepresentations cause the market to lower its expectations concerning the size of future cash flows, that is, to increase the riskiness of lending to the firm, the firm will be able to obtain financing only by paying a higher price (rate of interest). Professor Ayres mistakenly trivializes the effect of this phenomenon.

In addition, Professor Ayres ignores the agency cost implications of our arguments. Absent actual insider trading, misrepresentations that decrease the price of a firm's stock more likely further shareholders' interests than misrepresentations that increase the price of a firm's stock. This is true because misrepresentations that decrease the price of a firm's shares (or prevent it from rising) increase the probability of an outside bidder making a tender offer for the firm—an event that, if successful, usually results in target management losing its job. Managers, therefore, have an incentive to engage in misrepresentations to increase the value of a firm's shares, thereby reducing the probability of a hostile takeover, in order to entrench themselves in their jobs.⁴⁷ Consequently, where managerial misrepresentations decrease the firm's share price, it is unlikely (although not impossible) that the misrepresentations are made because of agency costs.

C. *Ayres's Warranty Default Proposal*

Professor Ayres appears to believe that firms can warrant the truth of their managers' statements only through the device of formal warranty.⁴⁸ In fact, this is not the case. As noted above, hiring outside auditors, lawyers, and investment bankers to verify the truth of corporate statements is a low-cost substitute for formal warranties.⁴⁹ Thus, little support seems to exist for Professor Ayres's argument that formal warranties are necessary for corporations to be able to speak credibly to the market.

Curiously, Ayres defends his proposed warranty by claiming that it would ensure that corporations internalize the costs of their decision

⁴⁷ Another self-serving reason why managers might falsify statements to inflate stock prices is to inflate their own salaries, given that the compensation of top corporate managers often is linked to the share price performance of the firms for which they work.

⁴⁸ See Ayres, *supra* note 1, at 952-53.

⁴⁹ See *supra* text accompanying notes 21-23.

to warrant (or not to warrant) their statements.⁵⁰ A scant three pages earlier, however, he argues that firms may not internalize the cost of misrepresentations that lower share prices.⁵¹ He cannot have it both ways. Either firms internalize the costs of their misrepresentations, or they do not.

Even ignoring this inconsistency, Ayres's analysis has two primary flaws. First, it falsely assumes that firms wanting to signal to the market that they are "in play" have no means of doing so besides simply declaring that they are in play. Not only is this incorrect, but a statement by corporate managers that the firm is in play will likely prove extremely ineffective. Instead, firms that want market participants to know they are in play will want to promise credibly that they will refrain from resisting an outside bid. This might be done by inserting provisions in the articles of incorporation that prevent the firm from resisting takeover bids.⁵² These sorts of provisions will prove far more effective than simply issuing statements of the kind Professor Ayres describes. Thus, more ways of precommitting to passivity exist than Professor Ayres appears to recognize.

The failure of Ayres's argument to appreciate the market's likely response to his warranty system presents a second and more fundamental flaw. He argues for a default warranty of honesty that would make managers' statements credible by holding managers personally liable for misrepresentations. In this respect, Ayres's scheme is identical to the current treatment of corporate misstatements under the antifraud rules. But Professor Ayres further argues that managers also should have the ability to give the market notice that a particular corporate statement "must be taken 'as is,' with no warrant of veracity."⁵³ Avoiding the conclusion that managers would accomplish nothing by making a false statement, and then declaring that the statement must be taken "as is," seems impossible. Unless the listeners suffered from collective brain damage, they inevitably would conclude that the statement was false if the corporation routinely warranted its other statements. Thus, Professor Ayres's warranty approach to corporate speech suffers from the same problems as the

⁵⁰ See Ayres, *supra* note 1, at 962.

⁵¹ See *id.* at 959-61.

⁵² See Haddock, Macey & McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 Va. L. Rev. 701, 726-33 (1987).

⁵³ See Ayres, *supra* note 1, at 962.

“no comment” approach: a corporation that switched from making statements under warranty to making a particular statement “as is,” like a corporation that switched its response to certain questions from “no” or “yes” to “no comment,” would fool no one.⁵⁴

II. MARKET EFFICIENCY AND FIDUCIARY DUTIES

Professor Ayres also argues that beliefs about whether the stock market is informationally or fundamentally efficient will determine shareholder preferences concerning corporate speech. Professor Ayres defines informational efficiency to be the state of affairs that exists when “certain classes of information are immediately incorporated into a stock’s price.”⁵⁵ Fundamental efficiency, according to him, exists if a stock price reflects only information relating to the “net present value of the corporation’s future profits.”⁵⁶ Professor Ayres claims his distinction between fundamental and informational efficiency is consistent with the famous analogy John Maynard Keynes drew between the stock market and the newspaper beauty contests of the 1930s.⁵⁷ Professor Ayres’s distinction differs fundamentally from Keynes’s analogy. It is also fundamentally incoherent.

Professor Ayres leaves us to wonder what, if anything, Keynes’s analogy has to do with his distinction between informational efficiency and fundamental efficiency. In a fundamentally efficient market, share prices for a stock will reflect the present value of future flows to shareholders.⁵⁸ Share prices in a fundamentally efficient mar-

⁵⁴ It may be that this is precisely the result Ayres seeks—a de facto prohibition on misrepresentation. If this is the case, then we fail to see any meaningful difference between his warranty default and a mandatory warranty rule.

⁵⁵ See Ayres, *supra* note 1, at 946.

⁵⁶ *Id.*

⁵⁷ Keynes likened investing in the stock market to competitions in which readers were asked to look at photographs of women’s faces in order to determine which contestants the readers as a group would find the prettiest. Thus readers were not asked who they thought was prettiest. Rather, they were asked who they thought other readers would think were prettiest. Of course, the winner of the contest would be the reader best able to predict what most of the other readers thought the average opinion to be. See *id.* at 968.

⁵⁸ Contrary to Professor Ayres’s assertion, see Ayres, *supra* note 1, at 969 n.97, fundamental efficiency does not require that stock prices equal the present discounted value of a corporation’s expected earnings. Earnings will only be reflected in a firm’s share prices to the extent that such earnings ultimately are paid out to shareholders. For example, if a firm has a new management team that is expected to double the firm’s earnings, the firm’s share prices still will not change if the new management pays all of those earnings out to itself in the form of salaries and bonuses.

ket will not change unless the market receives new information of an occurrence that reflects poorly on the firm's future cash flows. As a result, a market has fundamental efficiency if and only if it has the ability to "process" quickly new information about the firm's future cash flows.⁵⁹

If, in fact, fundamental efficiency implies informational efficiency, what then is the distinction Professor Ayres draws between fundamentally efficient stock markets and informationally efficient stock markets? The difference appears to be that informationally efficient markets may respond to certain information that has no bearing on corporate cash flows. For example, to use his own illustrations, if information about sunspots or the price of tea in China affects the price of IBM's shares, then, according to Professor Ayres, the market for IBM stock is informationally efficient, but not fundamentally efficient.

Professor Ayres's unproven, unelaborated assertion that stock markets simultaneously can be informationally efficient and fundamentally inefficient presents staggering implications. If true, then rational shareholders would want their managers "to trade-off underlying economic profits to increase the current stock price."⁶⁰ Followed to its logical conclusion, this argument at the very least suggests that much of corporate law simply is irrelevant to shareholder welfare. And, to the extent that Ayres asserts that a trade-off between fundamental and informational efficiency exists, his thesis militates in favor of overruling virtually all of the basic doctrines of corporate law, which obligate corporate management to maximize firm value. These include the fiduciary duties of care and loyalty, the corporate opportunity doctrine, and the director conflict of interest statutes, not to mention the many other doctrines grounded in the notion that corporate officers and directors have a residual obligation to maximize firm value for shareholders.

But with what are we to replace these rules? Professor Ayres agrees that shareholders will want managers to increase current share prices. But how will this be done? If the stock market lacks funda-

⁵⁹ "Processing" new information includes distinguishing among various forms of information, disregarding information that has no bearing on a firm's future cash flows, and assessing accurately the extent to which other information will in fact affect future corporate cash flows.

⁶⁰ Ayres, *supra* note 1, at 987.

mental efficiency, then no reason exists to believe that management has any control over share value—after all, management has no control over sunspots and the price of tea in China. If Professor Ayres is correct, then, not only does no reason exist to enforce positive disclosure obligations, but no coherent rationale exists for imposing fiduciary duties on officers and directors because such duties, to the extent they are effective, require management to maximize firm value.⁶¹ If maximizing firm value will not benefit shareholders because stock markets lack fundamental efficiency, then no reason exists to impose these rules on officers and directors.

Rather than adopt Professor Ayres's extreme position, we would say that, if information about sunspots or the price of tea in China affects the price of IBM's shares, the market for IBM's shares is behaving irrationally. If sunspots cause IBM's share prices to fluctuate, then we really do not have a theory that explains why share prices move. If share prices fluctuate because of sunspots, then no assurance exists that a merger announcement at a fifty percent premium over the current market price will cause that firm's stock to increase proportionally in value, or at all. After all, sunspots on the date of the merger announcement might counteract any upward pressure exerted by the merger announcement. Thus, Professor Ayres wrongly asserts that, regardless of fundamental efficiency, informationally efficient markets will generate detrimental price effects when corporations misrepresent themselves,⁶² because if markets are not fundamentally efficient, no basis exists for determining what effect, if any, new information will have on a firm's share price.⁶³

If courts cannot assess price changes in the absence of fundamental efficiency, how can they assess the effects of corporate disclosure at all? Indeed, in irrational markets, disclosure is wholly irrelevant,

⁶¹ If stock markets are informationally efficient but fundamentally inefficient, policymakers are in desperate need of some theory to explain what sorts of information affect share prices. As Professor Ayres's examples of sunspots and the price of tea in China suggest, we lack even the beginnings of a model of nonfundamental efficiency. As such, it is not surprising that the policy analysis in the second half of Professor Ayres's article is unsatisfying. We need some theory about the processes by which markets become efficient before we can discuss how the legal system should deal with the issue of corporate disclosure.

⁶² Ayres, *supra* note 1, at 984.

⁶³ Professor Ayres himself appears to acknowledge this point when he observes that "if the market is not fundamentally efficient . . . courts lose their ability to assess how much the price would have been but for the corporate misrepresentation." *Id.* at 984.

because disclosure will not have predictable effects on share prices. Evidently, a market cannot have fundamental efficiency unless it also has informational efficiency, because a market cannot achieve fundamental efficiency unless it can process information relating to corporate cash flows.⁶⁴ Equally clearly, a market cannot be fundamentally inefficient yet informationally efficient unless share prices move randomly and incoherently. If share prices move randomly and incoherently, then it seems inappropriate to hold corporate officers and directors responsible for misrepresentations as there is no way to know whether such misrepresentations in fact had any effect on share prices.

CONCLUSION

The first half of Professor Ayres's article examines the question of whether corporate misrepresentations should be actionable by shareholders. Professor Ayres correctly argues that the actionability of misrepresentations should be determined with reference to the fiduciary duties that corporate officers and directors owe to their shareholders. Professor Ayres also correctly says that corporations should be allowed to contract around their obligation to disclose truthful information, where nondisclosure or misrepresentation would maximize shareholder wealth. But, in our view, Professor Ayres fails to argue convincingly against our position that if firms were allowed to contract freely with their shareholders, the shareholders would, at times, find it in their interests to allow their officers and directors to make misrepresentations in order to protect corporate investments from the opportunism of outside parties.

In the second part of his article, Professor Ayres argues that securities markets can have informational efficiency without fundamental efficiency. Incoherent price movements would characterize markets that are informationally efficient but not fundamentally efficient. Lacking a theory about the effect of types of information on share prices, one simply cannot predict the effects of corporate misrepresentations on share prices. Similarly, the standard rationale for fashioning rules of corporate governance—to protect shareholders from managerial activities that transfer wealth from the shareholders to the managers—loses force because, unless we embrace the idea of funda-

⁶⁴ See *supra* notes 58-59 and accompanying text.

mental efficiency, we have no reason to assert that management activities—even misrepresentations—can harm shareholders.