

WHAT IS THE VALUE OF OTHER CONSTITUENCY  
STATUTES TO SHAREHOLDERS?

A fixed point of corporate law is that shareholders are, and should be, the ones whose interests count in corporate decision-making. This does not imply that shareholders systematically exploit other participants in the firm or otherwise defeat established expectations (notwithstanding the implicit assumption in Joseph Singer and Jacob Ziegel's papers);<sup>1</sup> such strategies are not in the shareholders' interest because the parties are in a repeated, long-term relationship, in which future cash flows matter. Rather, differences in claim characteristics provide shareholders with the best incentives regarding the long-term effects on the firm of a short-sighted redistribution move: (1) employees and bondholders periodically renegotiate their contracts with corporations as their relations have finite terms whereas common stock investments have no such term limit;<sup>2</sup> and (2) while workers cannot leave their jobs to their heirs, equity claims are transferable and expected to last beyond an individual's lifetime.

In the takeover setting, however, incentives change dramatically because it is an end-game: shareholders are cashing out their investments in the firm, and hence they will no longer bear any direct cost of diminished future cash flows from an opportunistic redistribution away from other firm participants.<sup>3</sup> This is one reason why the debate over bringing other constituencies into the boardroom has focused on takeovers (although management's self-interest in preserving its employment is, in my judgment, a far more potent explanation). But the best available

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1 Joseph William Singer 'Jobs and Justice: Rethinking the Stakeholder Debate' this issue; Jacob S. Ziegel 'Creditors as Corporate Stakeholders: The Quiet Revolution - An Anglo-Canadian Perspective' this issue

2 See Oliver Williamson 'Corporate Governance' 93 (1984) *Yale Lj* 1197.

3 To the extent shareholders hold portfolios of stock, then they will bear a cost, albeit an indirect cost, because other firms' stakeholders, as their periodic contracts come up for renegotiation, will demand increased compensation as protection against future exploitation in a takeover. An excellent example of this phenomenon is the accelerating inclusion of event risk provisions in public bond indentures after the great leveraged buy-outs in the mid-1980s, which produced huge gains for shareholders and downgradings in credit-ratings of straight debt. See Kenneth Lehn and Annette Poulsen 'Contractual Resolution of Bondholder-Shareholder Conflicts in Leveraged Buyouts' (1991) 34 *J. of Law & Econ.* 645.

data show, in a compelling fashion, that the sources of shareholder gains in takeovers are not redistributions from labour or bondholders.<sup>4</sup> As evidenced by this conference, these data have not, however, silenced the stakeholder debate.

Economic analyses of the optimal corporate governance structure could, and would, certainly abandon the shareholder-centred premise if some data were brought to bear that would warrant its adjustment or abandonment. Such data are lacking. Of course, we all have priors, held with varying degrees of confidence, on what would be good public policy. Consequently, updating beliefs can be a very slow process, even when the best available evidence is one-sidedly at odds with our beliefs. This understandable cognitive phenomenon accounts, in my judgment, for the differences between the MacIntosh and the Macey and Miller papers on one side,<sup>5</sup> and the Ziegel paper on the other; I do not think that it explains their differences with the Singer paper.

My view on stakeholder issues is similar to MacIntosh's, my differences with Macey and Miller are minor, on the level of second- or third-order quibbling, while my differences with Ziegel are, I think, in the realm of the stickiness of cognitive updating.<sup>6</sup> My difference with Singer involves, however, what I think is a disagreement over fundamentals: I place great value on being a citizen of a liberal democracy (and all the intellectual baggage associated with that),<sup>7</sup> and his paper seems to endorse a different world-view, despite the embrace of 'market' language, although I am not certain of the paper's aim beyond a call for extensive regulation.

Where does this leave me with respect to my role today as a commentator? As I have no interest in engaging in a silly rhetorical dispute over Singer's idiosyncratic use of terms such as 'a market system' and my disagreements with the other papers are insubstantial or turn on empirical assertions, I thought that the most fruitful use of time would be to introduce some new information on other constituency statutes that may aid in the updating of priors – the reassessment of positions on the statutes.

4 For a recent literature review see Roberta Romano 'A Guide to Takeovers: Theory, Evidence, and Regulation' (1992) 9 *Yale J. on Reg.* 119, 136–42.

5 Jonathan R. Macey and Geoffrey P. Miller 'Corporate Stakeholders: A Contractual Perspective' this issue; Jeffrey G. MacIntosh 'Designing an Efficient Fiduciary Law' this issue

6 For my view on the stakeholder issue, see Roberta Romano 'Corporate Governance in the Aftermath of the Insurance Crisis' (1990) 39 *Emory LJ* 1155, 1163–5; Romano, *supra* note 4, 171–3, 139–42.

7 See Roberta Romano 'Metapolitics and Corporate Law Reform' (1984) 36 *Stan. LR* 923.

*What is the value of 'other constituency' statutes to shareholders?*

There is at least one issue on which participants in the stakeholder debate agree: the impact of statutes or judicial decisions extending corporate governance rights to non-shareholder corporate constituents should adversely affect shareholders. This is the basis for opposition to extending management's fiduciary duty to non-shareholder groups: if a shareholder-centred fiduciary regime maximizes the value of the firm and hence is socially efficient, then shifting to an alternative regime will reduce firm value and result in an inefficient allocation of capital.<sup>8</sup> Similarly, the assumption motivating endorsements of other constituency legislation is that board decisions based on shareholder interests are inimical to the interests of the groups whose interests are to be included in board deliberations under the statutes; otherwise there would be no need to alter the current fiduciary regime.

This shared prediction concerning the impact of other constituency legislation on shareholders can be investigated by an event study, which involves use of conventional financial economic techniques to assess the impact of identifiable events, such as stakeholder legislation, on share prices. If shareholders are adversely affected by other constituency statutes, we would expect firms incorporated in legislating jurisdictions to experience statistically significant negative abnormal stock returns during the legislative process. Event studies of the effects of other takeover statutes have often found significant negative stock price effects.<sup>9</sup>

8 In the hypothetical bargain paradigm, legislation changing the fiduciary regime would be a windfall to stakeholders, who had already received some benefits in exchange for granting shareholders exclusive fiduciary rights.

9 Studies finding significant negative stock price effects are: Adam Broner *New Jersey Shareholders Protection Act: An Economic Evaluation* A Report to the New Jersey Legislature (Trenton NJ: Office of Economic Policy, State of New Jersey, 1987); Jonathan Karpoff and Paul Malatesta 'The Wealth Effects of Second Generation State Takeover Legislation' (1989) 25 *J. Fin. Econ.* 291; Jonathan Karpoff and Paul Malatesta 'PA: State Antitakeover Laws and Stock Prices' (July–August 1990) 46 *Fin. Analysts J.* 8; Donald G. Margotta 'Stock Price Effects of Pennsylvania Act 36' (unpublished manuscript) (1991); Michael Ryngaert and Jeffrey Netter 'Shareholder Wealth Effects of the Ohio Antitakeover Law' (1988) 4 *J. of Law, Econ. & Org.* 373; Michael Ryngaert and Jeffrey Netter 'Shareholder Wealth Effects of the 1986 Ohio Antitakeover Law Revisited: Its Real Effects' (1990) 6 *J. of Law, Econ. & Org.* 253; Laurence Schumann 'State Regulation of Takeovers and Shareholder Wealth: The Effects of New York's 1985 Takeover Statutes' (1989) 19 *Rand J. Econ.* 557; Gregory Sidak and Susan Woodward 'Corporate Takeovers, the Commerce Clause, and the Efficient Anonymity of Shareholders' (1990) 84 *Nw. ULR* 1092; Samuel H. Szewczyk and George P. Tsetsekos 'State Intervention in the Market for Corporate Control: The Case of Pennsylvania Senate Bill 1310' (1992) 31 *J. Fin. Econ.* 3.

It is possible that an alternative prediction could be derived from the breach of implicit labour contract story of takeovers.<sup>10</sup> Knowledge that takeovers will permit shareholders to breach implicit contracts will make stakeholders reluctant to enter into such contracts. If the contracts are ex ante efficient, then this is an undesirable state. To induce stakeholders to enter implicit contracts, shareholders need to be able to commit credibly that they will not tender their shares to a raider who will breach implicit contracts. The other constituency statute could be a precommitment device, guaranteeing that implicit contracts will be upheld in the takeover context. In this scenario, a statute's enactment should increase firm value (that is, a positive abnormal return is predicted).

To test whether other constituency statutes are detrimental to shareholders' interests, I undertook an event study of all other constituency statutes enacted by 31 December 1990, the last date of available stock returns on the University of Chicago's Center for Research in Security Prices (CRSP) computer tapes. Several states refined existing other constituency statutes during the study period, and in such instances, I selected the earliest statute's adoption as my event, with one exception, New York, where I used the later 1989 statute because there was uncertainty over the effect of the earlier 1987 statute.<sup>11</sup> Twenty-five states were included in the event study.

After identifying the statutes, I constructed a portfolio of New York Stock Exchange-traded firms incorporated in the legislating states. The sample consisted of 422 firms for which stock return data were available over my estimation period (from 250 days prior to the date of the legislation's introduction through the bill's enactment into law).

The change in stock price on the event dates that exceeds the stock's expected or normal return, termed abnormal returns or average residuals, was computed using conventional finance methodology, a market-adjusted beta excess returns model with parameters for the expected

10 See Andrei Shleifer and Lawrence H. Summers 'Breach of Trust in Hostile Takeovers' in Alan J. Auerbach (ed.) *Corporate Takeovers: Causes and Consequences* (1988) 33, which is discussed in MacIntosh, supra note 5, at section v, and Romano, supra note 4, 137-42.

11 See, e.g., Barbara Franklin 'Legislative Toss-Up' 6 July 1989 *NYLJ* 5. This appears to be related to the language of the earlier statute, which differs from other states' provisions, by only charging boards to consider 'long term and short term interests' rather than specific constituencies. For a list of the statutes included in the event study and their legislative histories see Roberta Romano 'What Is the Value of Other Constituency Statutes to Shareholders' (Yale Law School Center for Law, Economics and Public Policy Working Paper no. 155, 1992) appendix 1; for a list of the firms included see *ibid.* appendix 2.

returns estimated from days -250 to -10.<sup>12</sup> Residuals are examined on the following three events, separately as well as cumulatively: the day an other constituency bill is introduced; the first day a legislative chamber votes in favour of a bill; and the day the governor signs a bill into law. The results are collected in table 1. As indicated in section A of table 1, the signs of the average residuals on each of the three event dates is positive, but they are statistically insignificant (that is, we cannot conclude that the abnormal return is different from zero). Because it is possible that the information concerning legislative activity was not available for trades until the following day, I also cumulated residuals over event days 0 and +1 for each event. As section B of table 1 shows, the results are unchanged: the average residuals are positive and insignificant.

A possible explanation for the residuals' insignificance is that the event dates are legislative events, and not dates of press coverage. The event study methodology critically depends on accurately identifying the first public announcement of an event in order to distinguish abnormal returns within the specified statistical confidence range, and it is quite possible that investors are not aware of unreported legislative activities. The effect of this statistical problem is evident in the most comprehensive study of takeover statutes, by Karpoff and Malatesta, of 50 takeover statutes adopted in 31 states; the authors found a significant negative stock price reaction upon newspaper report dates but not on legislative event dates.<sup>13</sup> I was able to locate newspaper reports of only seven of the other constituency statutes. The average residuals for this subset of firms, using newspaper report dates as the event, are still insignificant.<sup>14</sup>

The use of legislative event dates rather than press dates is not a conclusive explanation of this study's insignificant results, because numerous studies of individual state takeover statutes have picked up significant negative returns on legislative event dates.<sup>15</sup> I also examined the returns for separate state portfolios, for twelve states with more than

12 Let  $A_{it}$  be the excess return for firm  $i$  on day  $t$ . Then,  $A_{it} = R_{it} - \alpha_i - \beta_i R_{mt}$ , where  $R_{it}$  is the return on firm  $i$  on day  $t$ ,  $R_{mt}$  is the return on the CRSP equally weighted index (the stock market proxy) on day  $t$ , and  $\alpha_i$  and  $\beta_i$  are ordinary least squares regression values from the estimation period,  $t = -250$  to  $-10$ . Note that as the event dates differ across the states, the aggregate portfolio is constructed in 'event time,' whereby each firm's 'day 0' is the date of bill introduction in its statutory domicile.

13 Karpoff and Malatesta, *supra* note 9, 308-9, 316

14 The sample consists of 195 firms in Florida, Illinois, Massachusetts, Minnesota, New York, Oregon, and Tennessee; the news reports for Florida, Tennessee, and New York appeared after the legislation's enactment. The average residuals ( $t$ -statistics in parentheses) are .0010 (.5426) for day 0 and -.0011 (-.4231) for the two-day sum of days 0 and +1.

15 See note 9, *supra*.

TABLE 1  
Abnormal returns on the enactment of other constituency statutes

Sample	Introduction	Vote <sup>a</sup>	Enactment <sup>b</sup>	3-day sum <sup>c</sup>
<i>A. Event day average residuals</i>				
Full sample	.0071 (.2115) n = 422	.0014 (.0430) n = 361	.0047 (.1368) n = 408	.0205 (.3012) n = 361
Enacted with other takeover laws	.0054 (.1874) n = 311	.0090 (.2965) n = 297	.0060 (.1983) n = 297	.0211 (.4009) n = 297
Not enacted with other takeover laws	.0012 (.5798) n = 111	-.0028 (-1.039) n = 64	.0004 (.0160) n = 64	-.0015 (-.3193) n = 64
Firms with poison pills	-.0001 (-.0447) n = 97	-.0007 (-.3164) n = 91	.0005 (.2481) n = 91	.0003 (.0833) n = 91
Firms without poison pills	.0110 (.2098) n = 271	.0124 (.2299) n = 217	.0084 (.1570) n = 264	.0358 (.3160) n = 217
<i>B. Two-day average residuals for days 0, +1</i>				
Full sample	.0160 (.3359) n = 422	.0117 (.2106) n = 361	.0117 (.2379) n = 408	
Enacted with other takeover laws	.0152 (.3689) n = 311	.0144 (.3335) n = 297	.0149 (.3464) n = 297	
Not enacted with other takeover laws	.0011 (.3928) n = 111	-.0007 (-.1794) n = 64	.0023 (.6025) n = 64	
Firms with poison pills	.0012 (.3746) n = 97	-.0002 (-.0669) n = 91	.0003 (.0996) n = 91	
Firms without poison pills	.0241 (.3248) n = 271	.0199 (.2147) n = 217	.0213 (.2307) n = 217	

Note: *t*-statistics are in parentheses; n = sample size

<sup>a</sup> Average residuals re-estimated to exclude 2 states with duplicate event dates

<sup>b</sup> Average residuals re-estimated to exclude 1 state with duplicate event dates

<sup>c</sup> Average residuals re-estimated to exclude 2 states with duplicate event dates

ten firms (sample size adequate to ensure that the statistics are valid). Of these, half of the portfolios had negative average residuals on the event dates, and half positive. But only one state's average residuals were statistically significant: this was the Indiana portfolio (19 firms), and they were negative.<sup>16</sup> These results are consistent with other event studies of state takeover statutes, which find either statistically significant negative abnormal returns or insignificant abnormal returns.<sup>17</sup>

Almost all other constituency statutes were enacted in conjunction with additional anti-takeover provisions, particularly in those states with the largest number of sample firms. As a consequence, the effect of other constituency statutes has not been truly isolated but is confounded with the impact of the other provisions. To control for this difficulty, the sample was divided into firms in states where an other constituency statute was enacted in tandem with other takeover regulation (17 states) and those in states where it was not. The latter portfolio consists of states where an other constituency provision was enacted separately or with non-substantive amendments to existing takeover regulation (3 states), or in tandem with other provisions concerning directors' duties, such as limits on liability for negligence or regulation of conflicts of interest (5

16 This replicates the results of Sidak and Woodward's event study of the Indiana control shares acquisition statute, *supra* note 9, which was in the same bill as the other constituency statute.

17 For studies finding significant negative results see note 9, *supra*. Studies finding no significant effects are: John S. Jahera and William N. Pugh 'State Takeover Legislation: The Case of Delaware' (1991) 7 *J. of Law, Econ. & Org.* 410; Donald G. Margotta and Swaminathan Badrinath 'Effects of New Jersey Shareholder Protection Legislation on Stock Prices (unpublished manuscript) (1987); Donald G. Margotta, Thomas P. McWilliams, and Victoria B. McWilliams 'An Analysis of the Stock Price Effect of the 1986 Ohio Takeover Legislation' (1990) 6 *J. of Law, Econ., & Org.* 235; William N. Pugh and John S. Jahera 'State Antitakeover Legislation and Shareholder Wealth' (1990) 13 *J. Fin. Res.* 221; Roberta Romano 'The Political Economy of Takeover Statutes' (1987) 73 *Va. LR* 111, 142-5. Some of the studies in the latter category, such as Margotta and Badrinath, *supra*, find significant negative residuals over only certain event time intervals and therefore conclude that the laws have no detrimental wealth effects. No study focused on the price effects of other constituency statutes, although there is some overlap of included statutes, given the multiple packaging of anti-takeover legislation; see note 16, *supra*, and the discussion at text following this note, *infra*. The Ohio statute included in my sample is not the same as the 1986 Ohio other constituency statute investigated by Ryngaert and Netter, *supra* note 9, and Margotta, McWilliams, and McWilliams, *supra*, because I selected the first stakeholder statute to be enacted in each state.

states).<sup>18</sup> As indicated in table 1, there is no significant difference in the average residuals across the two samples.<sup>19</sup>

An alternative explanation of this study's insignificant results involves confounding effects from sample firm characteristics. Researchers have found that the stock price effects of takeover statutes vary according to whether firms had adopted more potent takeover defensive tactics prior to the statutes' enactment: firms with poison pills do not experience significant negative returns whereas firms without poison pills do.<sup>20</sup> This pattern is consistent with the view of many practitioners that poison pills, rather than takeover statutes, are 'show stoppers.'<sup>21</sup> This could explain the insignificant residuals because poison pills came onto the scene in significant numbers only after 1986, and the event dates for the bulk of statutes in this study, unlike many of the studies that find significant negative returns, are well after 1986 when pills became widespread.

- 18 The states with no other provision or non-substantive amendments are Louisiana, Ohio, and New Jersey; those with limited liability statutes are Hawaii, New Mexico, and Wisconsin; and those with conflict of interest statutes are Mississippi and Wyoming. Event studies of limited liability statutes have not found significant stock price effects, except on the effective date, long after a statute's enactment would have been anticipated by investors. See Michael Bradley and Cindy Schipani 'The Relevance of the Duty of Care Standard in Corporate Governance' (1989) 75 *Iowa LR* 1; Vahan Janjigian and Paul J. Bolster 'The Elimination of Director Liability and Stockholder Returns' (1990) 13 *J. Fin. Res.* 53; Roberta Romano 'Corporate Governance in the Aftermath of the Insurance Crisis' (1990) 39 *Emory LJ* 1155. Hence, the impact of an other constituency statute's enactment at the same time as a limited liability statute is unlikely to be obscured by an offsetting confounding effect. All of the states in the newspaper sample, see note 14, *supra*, are states that enacted an other constituency statute in tandem with other takeover provisions.
- 19 None of the average residuals are significant for portfolios further subdividing the grouping of states that did not enact other constituency statutes in tandem with other takeover legislation. Portfolios for laws enacted with limited liability statutes (18 firms) and for those enacted with limited liability and conflict of interest statutes (20 firms) display significant negative returns the day before the vote date, significant positive returns the day after the introduction date, and negative returns that are significant at approximately 10 per cent on the introduction date. Portfolios for laws enacted with only insubstantial amendments (91 firms) experience significant negative returns on the day before the governor signing date. But in all of these cases, the average residuals, summed across both two- and three-day intervals surrounding the event date, are not significant.
- 20 Karpoff and Malatesta, *supra* note 9
- 21 For example, this view was emphatically articulated by Charles Exley, NCR's incumbent chief executive officer who failed to fend off American Telephone and Telegraph's hostile bid, in remarks at the ABA's National Institute on Dynamics of Corporate Control, held in New York on 5 December 1991, and by Thomas G. Cody, senior vice president for law and public affairs of Federated Department Stores, which eventually capitulated to Campeau Corporation's hostile bid, in remarks at the University of Cincinnati Law Review and College of Law's Conference on Regulating Corporate Takeovers, held in Cincinnati on 15 April 1988.

Accordingly, the data may be demonstrating that firms' efforts at self-help through defensive tactics render other constituency statutes superfluous.

To investigate this possibility, the sample was divided into firms with poison pills (97 firms) and firms that did not have pills (271 firms) during the legislative history events.<sup>22</sup> As indicated in table 1, the average residuals, on all event dates, are insignificant in both subsamples. In addition, while some of the residuals' signs in the poison pill portfolio are negative, they are uniformly positive in the no poison pill sample. There is, then, no evidence that self-help defences are obscuring an otherwise negative impact of other constituency statutes.

There is one further explanation of the findings of statistical insignificance in this event study that I find the most compelling: other constituency statutes are not perceived to have a negative wealth effect because they do not create dramatic changes in the common law of takeovers or in management's behaviour in responding to hostile bids. In this view, the statistical insignificance indicates that the market is predicting that courts will not interpret other constituency statutes adversely to shareholders.<sup>23</sup> To the extent that boards already are factoring in stakeholders' interest when engaging in defensive tactics, with judicial sanction, then enactment of an other constituency statute has no marginal effect on managerial decision-making, and hence on investor wealth. Consequently, investors do not alter projections of firms' future cash flows upon the statutes' enactment. This explanation seems particularly compelling because many other constituency statutes are added to state codes that already have restrictive takeover regulations in place, and the statutes do not provide stakeholders with enforceable

22 Sample firms with poison pills upon statute enactment were identified from the following sources: *Corporate Control Alert* (1985-1991 volumes); Investor Responsibility Research Center *Corporate Takeover Defenses* (1990); and SEC filings available through the NEXIS on-line database. For the firms' identification see Romano, *supra* note 11, appendix 2. Four firms were known to have poison pills but the year of the pill's adoption could not be ascertained, and three firms adopted pills during the legislative event time interval. These seven firms were therefore excluded from both the pill and no pill samples. In addition, the status of 47 firms not listed in the CCA as having a pill could not be conclusively identified as such (that is, the absence of a pill could not be confirmed from either IRR or SEC data). These 47 firms were not included in the no-pill regression discussed in the text. However, the no-pill regression was also estimated including these firms (318 firms, 263 excluding firms in states with duplicate event dates), and the results are indistinguishable from those reported in the text.

23 For one commentator's contention to this effect, see Charles Hansen 'Other Constituency Statutes: A Search for Perspective' (1991) 46 *Bus. Lawyer* 1355.

rights (that is, stakeholders cannot sue the board for what they deem to be an inadequate consideration of their interests).<sup>24</sup> The statutes, from this perspective, are merely window dressing. If stakeholder provisions have a function, it is solely for their symbolic value (legislators engaging in credit-claiming behaviour towards their non-shareholder local constituents).<sup>25</sup>

### *Conclusion*

Is value added or subtracted by other constituency statutes? The data identify no significant effect on investor wealth. One explanation is that the data – particularly the event's dating – are faulty. Although this objection cannot be summarily dismissed, when newspaper dates are used for a subsample of firms there is still the same result of no effect. It is, in my opinion, more likely that the prediction of a negative stock price effect is faulty. The story which best accords with the data is that other constituency statutes are not of much moment to investors because they have no effect on the law of takeovers. Board and court decisions on defensive tactics remain unchanged in the presence or absence of an other constituency statute. Consequently, such statutes are unlikely to deter hostile takeovers compared with alternative forms of takeover regulation and self-help defensive tactics such as poison pills. If flawed prediction, rather than flawed data, is the more persuasive explanation of this study's results, then the undue focus of participants in the stakeholder debate on other constituency statutes, as well as the belief that such statutes adversely affect shareholder wealth, needs reassessment.

24 See, e.g., *ibid.* 1372.

25 Cf. Roberta Romano 'The Future of Hostile Takeovers: Legislation and Public Opinion' (1988) 57 *U. Cin. LR* 457, 486 (suggesting congressional activity on takeovers during the 1980s served self-promotion purposes such as advertising, credit-claiming and position-taking).