FACT AND FICTION IN CORPORATE LAW AND GOVERNANCE

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INTRODUCTION

This issue of the *Stanford Law Review*, marking the Seventh Annual Conference on Empirical Legal Studies (CELS), provides each of its six authors an

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opportunity to address the impact of empirical work on important questions in our respective fields. In corporate law and governance, the impact of empirical work has been pervasive, as reflected by the fact that over one quarter of the papers submitted to CELS related to these topics. Beginning in the 1970s, theorists in economics and law laid the foundations of the field. With respect to key questions, however, theory could not provide an answer. For example, are staggered boards value enhancing? Are independent directors? Is separating the positions of CEO and board chair? For each of these questions, there is theoretical support on both sides. Empirical analysis is therefore necessary to answer them.

The same is true of the most fundamental question regarding corporate law—whether market forces promote optimal corporate governance arrangements, independent of law—a theoretical proposition that has framed the study of corporate law since the 1980s. There has been no systematic analysis of where this proposition stands in light of empirical evidence. In this Essay, I provide such an analysis. I conclude that, for the most part, the evidence is not supportive.

The theoretical framework within which we understand corporate law and corporate governance dates back to the finance literature of the late 1970s and the legal literature of the 1980s. In 1984, Roberta Romano commented that "[u]ntil recently, corporate law has been an uninspiring field for research."[1] She quoted Bayless Manning's famous statement in 1962 that "[c]orporation law, as a field of intellectual effort, is dead in the United States. . . . We have nothing left but our great empty corporation statutes—towering skyscrapers of rusted girders, internally welded together and containing nothing but wind."[2] From both an intellectual perspective and a legal perspective, a "revolution in corporate law"[3] began in 1976 with the publication of *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, by Michael Jensen and William Meckling.[4] That article developed a theory of agency costs in the public corporation, which remains the dominant framework of analysis for corporate law and corporate governance today. A year later, Ralph Winter published *State Law, Shareholder Protection, and the Theory of the Corporation*,

1. Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 923 (1984).

2. *Id.* at 1 n.1 (omission in original) (quoting Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 245 n.37 (1962)) (internal quotation marks omitted).

3. Roberta Romano, *After the Revolution in Corporate Law*, 55 J. LEGAL EDUC. 342, 347 (2005). A notable exception is the work of Henry Manne, which anticipated the literature on hostile takeovers that emerged twenty years later. *See id.* at 343; *see also* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967). And of course there was Ronald Coase, who first conceptualized the corporation as a contract in 1937. R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

4. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

an article that implicitly applied the Jensen and Meckling agency cost model to analyze the question of whether state competition to attract incorporations was a race to the bottom or a race to the top.[5] Then, in a series of articles published in the 1980s that culminated in a highly influential book, Frank Easterbrook and Daniel Fischel extended the Jensen and Meckling framework to develop what they called a positive and normative theory of corporate law.[6] Before long, this work and other legal scholarship grounded in economic theory began to influence the courts and the SEC.[7]

The view of the corporation that emerged over this period through the work of Jensen and Meckling, Winter, Easterbrook and Fischel, and others was a contractarian one.[8] The corporation was viewed as a "nexus of contracts" among "constituents," including managers, shareholders, creditors, employees, and others. Corporate law and governance focus primarily on the agency relationship between managers and shareholders. As in other market settings, the implication of conceptualizing the shareholder-manager relationship as contractual was that—in the absence of transaction costs—market forces could be trusted to maximize joint gains. In the corporate setting, this meant that market forces would lead the parties to create governance arrangements and adopt legal rules that would minimize agency costs and thereby maximize firm value.

The contractarian logic is clearest at the point of a company's initial public offering (IPO). Pre-IPO managers and investors design the firm's governance structure. The market sets the price of the company's shares—a price that is expected to reflect the effectiveness of the firm's governance structure in reducing agency costs—and investors buy those shares in the market. The pre-IPO shareholders are expected to reap the benefit of a good governance structure and the cost of a bad one. They are therefore expected to design optimal governance mechanisms that suit each firm's circumstances and to provide for

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5. Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

6. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 15 (1991) ("The normative thesis of the book is that corporate law should contain the terms people would have negotiated, were the costs of negotiating at arm's length for every contingency sufficiently low. The positive thesis is that corporate law almost always conforms to this model.").

7. *See* Romano, *supra* note 3, at 350.

8. Attempting to make a list inevitably means omitting some influential articles of the time. The following are just a few: OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING (1985); Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); David D. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987); Henry Hansmann, *Ownership of the Firm*, 4 J.L. ECON. & ORG. 267 (1988); and Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978).

those mechanisms in the firm's charter—the "corporate contract."[9] As a normative matter, contractual governance is seen as superior to legally imposed governance arrangements because firms are different along numerous dimensions and market forces create incentives to customize and to innovate. If the contractarian theory is valid, we would expect to find that companies going public include in their charters customized and innovative governance arrangements.

Once shares of a company are dispersed among public shareholders, there remains a question whether management can take advantage of its control to loosen the governance reins and promote its own interests.[10] Here too, contractarian theorists argued that market forces would induce management to adopt optimal governance arrangements.[11] Empirical support for this element of the theory would take the form of public company management initiating value-enhancing charter amendments or otherwise adopting governance improvements to minimize agency costs.

The contractarian view of the corporation casts corporate law in a supporting role. Corporate law provides "off-the-rack" default rules that save the parties the cost of customizing the terms of their entire relationship.[12] Where management can improve on those default rules, it will opt out of them and draft alternatives into the company's charter, either at the IPO stage or later. In addition, in the United States, the applicable default rules are themselves a matter of contract. When a firm goes public, it selects a state in which to incorporate, and in so doing, it opts into that state's body of corporate law. Once public, the firm can reincorporate with the approval of the firm's board and its shareholders. The contractarian understanding is that a firm will incorporate in a state whose corporate law best reduces its agency costs. Moreover, following Winter, contractarians expected states to be eager to collect the franchise fees that come with incorporation and therefore to compete with each other to provide corporate law that meets this demand—to "race to the top."[13]

The contractarian theory brought economics into the analysis of corporate governance and corporate law, and in doing so it provided a fresh start based on simple assumptions and straightforward economic logic. In the absence of transaction costs, economic theory implies that managers will customize the terms of their relationship with shareholders to maximize firm value.[14] This

9. Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989) (characterizing corporate charters as contracts).

10. For an overview of this issue, see Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

11. Haddock et al., *supra* note 8, at 733-37.

12. EASTERBROOK & FISCHEL, *supra* note 6, at 34.

13. Winter, *supra* note 5.

14. For simplicity and to conform with the terms of the literature, I use the term "firm value" to refer to the joint wealth of managers and shareholders, without taking into account

was the core implication of the contractarian theory, and the one that provided the contractarians with a powerful normative claim—that there was essentially no need for legal intervention because whatever is needed would be accomplished by contract. There remained a question, however, whether the terms of actual corporate contracts are what the contractarians expect, or whether market imperfections impede the establishment of optimal governance arrangements. This is an empirical question, on which the positive and normative contractarian position hinged, and the question on which I focus in this Essay.

On the whole, the empirical literature over the past three decades has provided little support for the contractarian theory.[15] Key pillars of the theory do not match the empirical facts. First, contractarian theory implies that the charters of companies going public will be a locus of vibrant value-maximizing innovation and customization. Empirical evidence, however, shows that essentially no innovation or customization occurs in IPO charters and that these charters are virtually empty from a governance perspective. At the IPO stage, firms adopt the default rules or statutory options of the state in which they are incorporated.[16] The only significant governance provisions that appear in IPO charters are staggered boards, which studies have shown to be value reducing.[17] Second, empirical studies have shown that state competition in the provision of corporate law does not exist.[18] There is no race to the top or to the bottom. Delaware is the only state in the race, and it dominates the market.

Once companies go public, the data on midstream adjustments to the corporate contract is mixed. The empirical evidence does not support the proposition that the invisible hand quickly dispenses with inefficient governance mechanisms, or that it induces management to propose innovative or customized charter amendments for shareholder approval. Instead, shareholders have been engaged in a very visible battle with managers over governance for well over three decades. The results of the battle favored management for most of that time. In recent years, however, the balance of power seems to have shifted toward shareholders. After a thirty-year delay, and key changes in the background law, governance structures that shareholders advocate have been adopted.

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the possibility that actions they take have external effects on the wealth of other constituents of the firm.

15. In an earlier article, I discussed theoretical challenges to the contractarian theory. *See* Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779 (2006).

16. Statutory options include, for example, staggered boards, cumulative voting, and exculpation from monetary liability for outside directors. *See* DEL. CODE ANN. tit. 8, §§ 102(b)(7), 141(d), 214 (2013). Firms tend not to contract out of state antitakeover provisions. *See* Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Provisions in IPOs*, 17 J.L. ECON. & ORG. 83, 95 (2001).

17. *See infra* Part III.A.1.b.

18. *See infra* Part II.

Why does the contractarian theory fail to fit the facts? The answer necessarily lies in transaction costs or other market imperfections. The contractarians assumed that the relevant transaction costs were drafting costs, which could not be high enough to undermine the theory in any significant way, and that there were no other market imperfections. But instead, market imperfections are more complex and more important than the contractarians realized. In defining the rights and obligations of the shareholder-manager relationship, general standards are often more suitable than specific rules. Fiduciary duties in various contexts are an example. When this sort of contract term is needed, the content of the term is provided through judicial interpretation in particular contexts. The more firms there are that have adopted a governance rule, the more the term will be litigated and the more judicial interpretations there will be. Consequently, because a default rule is likely to be widely adopted—if only due to its focal quality—it provides the benefit of not only a current stock of precedents, but a future flow as well. This is not true of a term that a single firm customizes. In addition, a default rule offers the benefits of familiarity in the market and familiarity among lawyers who may be called on to provide advice.

In prior work, I have explained this phenomenon in terms of the economics of network technologies.[19] The network benefits of a default rule can outweigh the inherent benefits of a term that a firm might tailor to fit its own circumstances—just as the network benefits of the Windows operating system can outweigh the benefits of a new operating system that a specialized computer manufacturer might consider developing. It can also outweigh the inherent benefit of an innovation that is potentially attractive to many firms. Network benefits are theoretically available for customized and innovative terms (and for new operating systems) but only if they become widely adopted—and a collective action problem stands in the way of widespread adoption. As I discuss, however, this could be changing with respect to governance arrangements that are the subject of high-visibility campaigns by shareholder activists.

A second reason the contractarian theory has failed to fit the facts is that the contractarians paid little attention to actual corporate contracts. In fairness, in 1984, Easterbrook recognized that contemporary empirical studies were limited and that further empirical work would be useful.[20] But short of a full study,

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19. Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 826-29 (1995); *see also* Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 1, 9-10 (2006) (making a similar point focusing on statutory amendments, which can provide value independent of how many firms adopt a default rule). Ian Ayres made a related point with respect to the design of corporate law default rules. He argued that they should be general standards that a court will apply ex post, and that firms that opt out would do so with specific rules that require no such ex post application. Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1403-08 (1992) (reviewing EASTERBROOK & FISCHEL, *supra* note 6).

20. Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 552 (1984).

a review of a few corporate charters would have revealed that the real-world facts differed in important ways from what the contractarian theory implied.[21]

The empirical literature has filled in some of the facts that the contractarian theorists missed, and in doing so it has left little if anything of the theory standing. This is the primary theme of this Essay. But just as the contractarian theorists failed to pay sufficient attention to real-world facts, many empiricists also fail to understand the governance mechanisms that they include in their models. As a result, some models are substantively flawed, and we cannot be as confident in their results as we might otherwise be. The failure of corporate law and governance scholars to pay sufficient attention to institutional facts is thus a secondary theme of this Essay.

This Essay will proceed as follows. In Part I, I explore the contrast between the contractarian understanding of the IPO stage and the reality revealed by the empirical literature. In support of that analysis, I present some simple findings from new data that I have collected from IPO charters. In Part II, I review the empirical literature on the "race" among the states to provide corporate law. In Part III, I examine the extent to which the empirical literature bears out the contractarian prediction that market forces will promote optimal adjustments to governance arrangements once a company goes public. Finally, in Part IV, I briefly pursue the secondary theme of this Essay by addressing some ongoing misconceptions in the empirical literature regarding takeover defenses and the use of governance indices.

I. CONTRACTING AT THE IPO STAGE

When a company goes public, its charter is, in effect, a contract between its management and its public shareholders. The charter confers legally binding rights on shareholders and obligations on managers. The charter can commit the company to forgoing a poison pill, to having a staggered board, to limiting directors' exposure to liability risk, to separating the positions of CEO and board chair, to maintaining a board of a specified size, to having a certain number of independent directors on the board, to requiring managers to hold a certain amount of stock, to compensating management in a certain way, and so on. There are few limits to this freedom.[22] Any provision included in the firm's

21. For example, Easterbrook and Fischel state: "[F]irms go public in easy-to-acquire form: no poison pill securities, no supermajority rules or staggered boards." EASTERBROOK & FISCHEL, *supra* note 6, at 205. This is not true. Similarly, Haddock et al. state: "Shareholders in many firms have . . . refused to install poison pill provisions in their charters." Haddock et al., *supra* note 8, at 734. Poison pills are not instituted through corporate charters and do not require shareholder approval, so it is unclear what they were referring to. What Haddock et al.'s analysis would lead us to expect in at least some charters is a provision preventing or limiting a board's adoption of a poison pill. Yet none of the studies of IPO charters report finding such a provision in even a single charter.

22. The only limit to the corporate governance commitments a company can include in its charter is that it cannot contradict a legal requirement of the state in which it incorpo-

charter can be changed later on only with the approval of the board and the shareholders.

Pricing is the linchpin of the contractarian theory. The governance commitments that a firm includes in its charter are disclosed to the market at the time the firm goes public. Investors have the opportunity to evaluate them just as they evaluate other aspects of the company. The securities market is expected to price governance arrangements provided for in a firm's charter, just as it prices the quality of a firm's business model, its products, its management, and anything else that may influence its future profits and therefore its present value.[23] If a governance commitment is valuable, investors are expected to bid up the price of the company's stock, in which case those who own shares in the company prior to the IPO reap the benefits. Under contractarian logic, therefore, pre-IPO managers and investors are expected to write charters that provide for value-maximizing governance mechanisms. Whether or not they do so is an empirical question.

A. *IPO Charters and Takeover Defenses*

The optimality of corporate governance commitments contained in the IPO charter was the least controversial element of the contractarian theory. IPO charters were expected to provide for value-enhancing governance mechanisms. Even skeptics of the contractarian theory acknowledged that its claims with respect to the IPO stage were the strongest.[24] The only other proposition about which contractarians were as certain (and that skeptics also agreed upon) was the proposition that takeover defenses entrenched management and reduced firm value.[25] Takeover defenses, therefore, were not expected to be included in IPO charters. Easterbrook and Fischel stated both views as a statement of fact:

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rates—which, as discussed below, is itself a matter of contract. For example, the Delaware General Corporation Law provides:

> [T]he certificate of incorporation may also contain any or all of the following matters:
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> (1) Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, . . . if such provisions are not contrary to the laws of this State.

DEL. CODE ANN. tit. 8, § 102(b) (2013). Regardless of the state of incorporation, this legal constraint is not a strong one.

23. Easterbrook and Fischel state: "The mechanism by which stocks are valued ensures that the price reflects the terms of governance and operation, just as it reflects the identity of the managers and the products the firm produces." EASTERBROOK & FISCHEL, *supra* note 6, at 18.

24. *See, e.g.*, Bebchuk, *supra* note 10, at 1404 ("It is in this context that the case for contractual freedom is the strongest.").

25. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1164 (1981).

> If investors value [a takeover defense] . . . it should be included in the articles of incorporation or securities as firms go public. If valued, these devices would enable the entrepreneurs to get extra money for their venture. *Yet they are not included*. Instead firms go public in easy-to-acquire form: no poison pill securities, no supermajority rules or staggered boards. Defensive measures are added later, a sequence that reveals much.[26]

Whether IPO charters in fact contain takeover defenses is an empirical question that would not be investigated for another decade. Easterbrook and Fischel apparently made the factual statement above based on theory, not actual observation. And for the next decade, the theory was so widely accepted that no one thought it was worth reading actual charters to validate it even anecdotally.

Three articles published in 2001 and 2002 presented data on the charters of firms going public. Surprisingly, they found that IPO charters commonly contain takeover defenses—most importantly, staggered boards—which cast doubt on whether IPO charters are in fact value maximizing.[27] The studies covered different sample periods between 1988 and 1999 and found that between 34% and 82% of sample firms had staggered boards, with a higher frequency in later years.[28] In a more recent study of firms that went public between 1997 and 2005, about 64% of firms had staggered boards.[29]

Two of these articles analyzed whether there might be efficiency explanations for some companies' adoption of a staggered board. Laura Field and Jonathan Karpoff as well as Robert Daines and I explored whether staggered boards are adopted by firms that need extra bargaining power in the event a hostile bid is made.[30] Neither study found support for this explanation. Daines and I also tested whether staggered boards tended to be adopted by firms whose value was difficult to discern and that were therefore relatively vulnerable to bids lower than their true value. We found no support for this explanation either. In fact, Daines and I found that staggered boards tended to be *most* prevalent when these efficiency theories suggested that they would be *least* needed and where management entrenchment seemed to be the best explanation.[31]

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26. EASTERBROOK & FISCHEL, *supra* note 6, at 204-05 (emphasis added).

27. *See* Daines & Klausner, *supra* note 16.

28. John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CALIF. L. REV. 1301, 1353 tbl.3, 1377 & fig.3 (2001) (summarizing the results of four sample periods and noting that defenses became more common in the late 1990s); Daines & Klausner, *supra* note 16, at 96 tbl.2; Laura Casares Field & Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, 57 J. FIN. 1857, 1861 tbl.II (2002).

29. E-mail from William C. Johnson, Assistant Professor, Sawyer Sch. of Bus., Suffolk Univ., to author (Jan. 11, 2013) (on file with author) (confirming the aggregated percentage of all IPO firms with staggered boards based on their dataset); *see also* William C. Johnson et al., The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms 33 (April 29, 2013) (unpublished manuscript), *available at* http://ssrn.com/abstract=1923667.

30. Daines & Klausner, *supra* note 16, at 98-99; Field & Karpoff, *supra* note 28, at 1857-58.

31. Daines & Klausner, *supra* note 16, at 102, 104.

John Coates investigated whether a firm's lawyer influences the adoption of a staggered board, and he found that it did. He found that law firms with extensive transactional or litigation work involving mergers and acquisitions instill in their lawyers, or in the form charters that their lawyers use, a preference for takeover defenses.[32] This is hardly evidence of value maximization at work. Regarding the pricing of takeover defenses at the IPO stage, Coates states: "A lack of pricing penalty is also consistent with anecdotal reports from IPO participants, including investment bankers, venture capitalists, and lawyers from Wilson Sonsini (among other lawyers), who all uniformly report in conversations that conventional defenses do not affect IPO pricing."[33]

Since most pre-IPO shareholders, including venture capitalists, continue to own shares for a period of time after the IPO and later distribute them to their investors, Coates's pricing explanation for the presence of takeover defenses would have to extend to pricing in secondary market trading after the IPO as well. The findings of all three of these articles are consistent with this explanation. Notwithstanding compelling contractarian logic, if lawyers, underwriters, and venture capitalists do not believe takeover defenses affect share prices in an IPO or in the secondary market in the period following an IPO, perhaps market participants generally do not believe they do—in which case they won't. There is always the possibility, however, that new research will bring new variables into the analysis that will support faith in efficient markets and the optimality of contracting at the IPO stage.

William Johnson, Jonathan Karpoff, and Sangho Yi suggest such a variable in a recent paper, an earlier version of which the authors presented at CELS. They show that takeover defenses among companies going public are common in firms that have substantial contractual commitments to business partners—

32. Coates, *supra* note 28, at 1336-37, 1377. Following the publication of my article with Daines, we held a conference on takeover defenses in IPO charters for venture capitalists and institutional investors at Stanford Law School. After the discussion had gone on for some time, a senior venture capitalist said, with mild disdain: "I've been around this business for thirty years and I have never, ever thought about whether these defenses make any difference in the pricing of shares, and I have never, ever heard a banker raise the issue."

33. *Id.* at 1381-82. At the time, the thought that charter terms might not be priced constituted ideological incorrectness, something akin to heresy or political incorrectness. After Daines and I circulated a draft of our article, I had dinner at a conference with a group of senior corporate law academics. Upon sitting down, one said to me with only slight condescension: "So, I hear that you and Daines believe that after 700 years of securities markets, investors still do not know how to price takeover defenses in IPOs." The safe response from an aspiring junior academic—and a response that was technically correct—was that Daines and I did not comment on whether takeover defenses were priced. Today, this orthodoxy has subsided and the issue of whether the market prices governance arrangements is a legitimate research question. *See* Lucian A. Bebchuk et al., *Learning and the Disappearing Association Between Governance and Returns*, 108 J. FIN. ECON. 323 (2013) (analyzing the market's pricing of good and bad governance arrangements); Martijn Cremers & Allen Ferrell, Thirty Years of Shareholder Rights and Stock Returns (Dec. 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=2020471 (same).

customers, suppliers or strategic partners.[34] Their analysis suggests that, for these firms, takeover defenses are value enhancing because they provide assurance to business partners that the relationship will last, and they thereby encourage their partners to invest in these relationships. In other words, takeover defenses can be an efficient complement to a relationship-specific investment.[35]

Johnson et al. provide support for the proposition that some firms adopt value-enhancing governance mechanisms at the IPO stage. But they provide only a partial answer to the puzzle of why firms commonly adopt takeover defenses when they go public. The authors find that 65.6% of firms with large customers have staggered boards and 60.6% of firms *without* large customers have staggered boards (a difference that is statistically significant).[36] Thus, while Johnson et al. provide an impressive explanation of why a substantial number of firms adopt staggered boards, there are still many firms in their sample whose staggered boards remain unexplained in terms of efficiency.

Johnson et al.'s results also raise another question: do relationship-specific investments require that takeover defenses remain in effect *in perpetuity*? Even if, on balance, takeover defenses are value increasing for young firms with long-term relationships, the fact that defenses remain in effect in perpetuity raises the question of whether they are in fact value maximizing. They could instead sunset or require shareholder approval after a period of time, but no IPOs reported in any studies are limited in this way.

Also, with respect to pricing, Johnson et al. show that takeover defenses increase share value for firms with important business relationships. For firms with no such relationship, takeover defenses have no significant impact on share price.[37] Although this incidental finding is just a null result, it bears noting because it is the only direct test of the contractarian pricing claim.[38] This difference is difficult to explain.

In sum, even with Johnson et al.'s results, the presence of takeover defenses in IPO charters is problematic for the contractarian theory. It raises questions about whether governance terms are priced when they are included in the IPO

34. Johnson et al., *supra* note 29.

35. *See* Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 53 (Alan J. Auerbach ed., 1988). Johnson et al. use a takeover index as their dependent variable, which, as explained in Part IV, is problematic. But they report that their results are unchanged if they instead use the presence of a staggered board. Johnson et al., *supra* note 29, at 32-33.

36. Johnson et al., *supra* note 29, at 33. Their findings are similar with respect to firms with and without dependent suppliers and strategic partners. *Id.*

37. *Id.* at 24.

38. Since the authors' dependent variable in this part of the analysis is a score on a takeover index, we should interpret the null result with even more caution. *See infra* Part IV. But whatever the index is measuring, there is a result for firms with important relationships to protect and none for those without such relationships.

charter, and it raises a question of whether IPO charters are in fact value maximizing.

B. *Innovation, Diversity, and the "Plain Vanilla" Charter*

In order to determine whether IPO charters are a source of governance innovation and whether companies customize governance commitments to suit their unique circumstances, I did some additional data collection for this Essay. I took a random sample of 373 companies that went public during the period from 2000 through 2012,[39] and I searched their charters (and bylaws) for examples of governance innovation and customization.[40] I looked for any nonstandard governance measure, but to lend some structure to the search, I specifically searched for governance arrangements that have been salient in corporate governance debates over the past two decades, including, for example, separation of the CEO and board chair and any other provision related to board independence. I also looked for governance innovations that have emerged in recent years. Some of these innovations have become mandatory as a result of either legislation or SEC regulation—majority independent boards, independent board committees, proxy access, and say on pay. A fifth innovation—majority voting in shareholder elections of directors—is not legally required, but in response to pressure from institutional investors, it has been widely adopted and shown in some studies to be value enhancing.[41]

For each of the governance innovations reviewed above that has become legally mandatory, I investigated whether it appeared in IPO charters while shareholder activists were advocating it, but before it became legally required. For majority voting, I investigated whether it appeared in IPO charters since the beginning of 2005, the year in which it began to gain the attention of institutional investors. If an innovation appears in IPO charters, we could infer that, indeed, IPO charters may be a source of governance innovation. If an innovation does not appear in IPO charters, there are two possible implications. First, IPO charters may not perform the function that the contractarian theory ascribes to them; they may not be a source of innovation. Alternatively, these particular innovations may not be value enhancing for any of the firms in the sam-

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39. The sample included thirty companies per year, except for 2008, when there were fewer than thirty IPOs. I omitted spin-offs, carve-outs, blank check companies, regulated financial institutions, and real estate investment trusts.

40. A company's charter may authorize the board to amend its bylaws. DEL. CODE ANN. tit. 8, § 109 (2013). Typically such authority is provided. Consequently, a governance provision included in bylaws does not have the same contractual quality as does a charter provision, which can be amended only with the agreement of the board and shareholders. In theory, however, a charter could impose limits on the board's authority to amend bylaws—for example, by disallowing unilateral board amendments to certain provisions. Therefore, where a company's bylaws contain an innovation, I searched the charter to determine whether there were any restrictions on amending it. I found no such restrictions.

41. *See infra* notes 149-153 and accompanying text.

ple. This is the classic contractarian inference: if it is not adopted by firms going public, then it is not value enhancing (and it should not be legally required).[42] If I find that these governance structures are adopted by some but not all companies, one explanation might be that, as the contractarian theory assumes, firms are diverse and adopt governance structures to suit their particular needs.

Table 1 presents my findings.[43] In short, IPO charters are not the vehicle of governance innovation and customization that the contractarian theory posited. First, *no* charter contained any innovation or nonstandard term. A few firms, however, included such terms in their bylaws (which can usually be unilaterally amended by the companies' boards). Of the 373 firms sampled, the bylaws of seven firms contain a governance commitment beyond standard takeover-related provisions and corporate housekeeping arrangements—each of the seven firms adopted one such provision. The fact that no charter included any of these terms, and that only a handful of bylaws did, may mean that no such in-

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42. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 6, at 204-05 (arguing that rules mandating auctions would be included in IPO charters if they were the value-maximizing response to hostile offers); Haddock et al., *supra* note 8, at 728 (arguing that rules mandating passivity would be included in IPO charters if they were the value-maximizing response to hostile offers).

43. Time periods in Table 1 begin either on January 1, 2000, the first date of the sample period, or at the point at which each mechanism first received significant public attention. The periods end either on December 31, 2012, the last day of the sample period, or on the date at which a mechanism became legally mandatory. For independent committee requirements, the SEC approved rules issued by the New York Stock Exchange and the NASDAQ on November 4, 2003. Those rules, which required firms listed on those exchanges to have compensation, nominating/corporate governance, and audit committees consisting entirely of independent directors, were effective beginning with a company's first annual meeting after January 15, 2004 (or no later than October 31, 2004 if there was not an earlier annual meeting). I therefore use April 1, 2004 (the traditional start of the proxy season) as the relevant starting date for this rule. NASD and NYSE Rulemaking: Relating to Corporate Governance, Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154 (Nov. 12, 2003). For proxy access, I use the date on which the AFSCME filed a shareholder proposal with American International Group in 2005, which the United States Court of Appeals for the Second Circuit upheld. *See* AFSCME v. Am. Int'l Grp., 462 F.3d 121, 123 (2d Cir. 2006). For majority rule, CalPERS issued a press release on March 14, 2005 announcing that it would begin advocating majority vote elections. Press Release, CalPERS, CalPERS to Seek Majority Vote for Corporate Directors (Mar. 14, 2005), *available at* http://www.calpers-governance.org/marketinitiatives/initiatives/press-releases/majority-vote-for-directors. For say on pay, the AFSCME filed shareholder proposals with eight companies in 2006. *See* CHALLIE DUNN & CAROL BOWIE, RISKMETRICS GRP., EVALUATING U.S. COMPANY MANAGEMENT SAY ON PAY PROPOSALS: FOUR STEPS FOR INVESTORS 4-5 (2009), *available at* http://www.shareholderforum.com/sop/Library/20090316_RiskMetrics.pdf. The SEC's say-on-pay rule became effective on April 4, 2011. Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Securities Act Release No. 9178, Exchange Act Release No. 63,768, 76 Fed. Reg. 6010 (Feb. 2, 2010). Differences in totals reflect shorter and longer time periods relevant for each mechanism. No companies that went public prior to these years, however, had any of these provisions in their charters or bylaws. Therefore, the selection of starting dates has no impact on the findings.

novation or customization is value enhancing for essentially any firm. But there is considerable evidence that this is not true. Many firms separate their CEO and board chair, many had a majority of independent directors before the Sarbanes-Oxley Act of 2002 required it, and many have had a supermajority of independent directors since Sarbanes-Oxley. With respect to governance innovations of more recent years, it is possible that none enhance value for any company. Perhaps institutional investors are wrong in their advocacy of majority voting. But as discussed below, there is evidence that majority voting *is* value enhancing and even stronger evidence that it makes management more responsive to shareholders.[44] As for the governance arrangements that are now legally required, they may be value reducing for essentially all firms. Again, perhaps institutional investors were dramatically wrong in advocating these measures before Congress and the SEC, and perhaps Congress and the SEC were wrong to adopt them—so wrong that these provisions fail to enhance value in *any* firm. But it seems unlikely that this explains the complete absence of these provisions from IPO charters. Occam's razor would point to another explanation: there is something about IPO charters that, contrary to the contractarian theory, makes them unsuitable as a source of governance innovation or customization.[45]

TABLE 1
Incidence of Governance Innovations or Customization
in IPO Charters or Bylaws

	Relevant Period	Yes	No	Total
Independent Compensation Committee	1/1/00 to 4/1/04	1	125	126
Independent Nominating Committee	1/1/00 to 4/1/04	0	126	126
Independent Governance Committee	1/1/00 to 4/1/04	0	126	126
Proxy Access	1/1/05 to 12/31/12	0	224	224
Majority Rule	1/1/05 to 12/31/12	4	220	224
Say on Pay	1/1/06 to 4/4/11	0	143	143
Separation of CEO and Board Chair	1/1/00 to 12/31/12	2	371	373

* * *

The IPO stage is the core of the contractarian theory. The charters of firms going public are where the innovative and customized contracting is supposed

44. *See infra* notes 149-153 and accompanying text.

45. Another possible explanation is that governance mechanisms suitable for established firms are unsuitable for firms going public. This explanation, however, is unconvincing. If it were true, IPO charters would have provisions that, for example, require management to allow shareholders to vote to approve or disapprove certain governance arrangements five years following the IPO. It would not explain the complete absence of such provisions.

to occur. Empirical research, however, has shown that it does not. Corporate charters are "plain vanilla" with statutory takeover defenses commonly added, and nothing more. There is variation in that some companies have staggered boards and some do not. Johnson et al.'s analysis suggests that some of this variation may be explained in efficiency terms—as a means of cementing important long-term business relationships. But there are many firms whose defenses cannot be explained this way, and, even for those that can be explained on this basis, the perpetual duration of staggered boards raises doubt.

The relationship between shareholders and managers is certainly contractual in the broad sense of that term. Shareholders enter into the relationship voluntarily. The empirical literature, however, leads to either of two implications—both at odds with the contractarian theory. First, there may be impediments that prevent the sort of value-maximizing contracting that the contractarians expected, or second, the value-maximizing terms for essentially all firms are the default terms provided by corporate law.

A combination of both of these explanations has a basis in economic theory—just not the theory of frictionless markets. As I have explained elsewhere, the economics of networks explains how each individual firm may maximize its own value by adopting a default rule or other standardized governance provision, and how by doing so all firms in the aggregate may fail to maximize their collective value.[46] Corporate governance arrangements and legal rules have some of the same qualities as network products such as software, computer operating systems, and online communities, which increase in value as more people use them. The more firms there are that use a governance arrangement, the more valuable it becomes. This value stems largely from current and future judicial precedents interpreting the legal requirements of the arrangement. Precedents are particularly valuable when a governance arrangement entails a legal or contractual rule that is an open-ended standard, as opposed to a specifically defined rule. In the corporate governance context, open-ended standards are common. Fiduciary duties, concepts of independence for directors, and disclosure requirements for shareholder votes are examples. An additional network benefit of governance arrangements is the familiarity of lawyers providing advice. If a governance arrangement has such network benefits, then customizing alternatives or developing innovations may not be attractive. The value of a widely used term, simply because it is widely used, may be greater than the value of a term that is well tailored to a firm's particular circumstances or that is a potentially valuable innovation to a large number of firms.

This could explain why firms going public have charters that are essentially silent with respect to governance and that, by their silence, adopt default rules. Default rules have already been widely adopted and can be expected to be widely adopted in the future. Pre-IPO managers and shareholders may maximize the value of their own firms by simply adopting default rules rather than

46. *See* Klausner, *supra* note 19.

customizing or innovating terms as the contractarian theory implies they will do. But from a societal point of view, there may be a suboptimal level of innovation and customization. Moreover, the default rule may be suboptimal. Even accepting the fact that all firms will adopt a default rule, it could be that an alternative default rule will increase their value.

II. STATE COMPETITION TO PROVIDE CORPORATE LAW

When a company goes public, it chooses a state in which to incorporate. The corporate law of that state will govern the relationship between its managers and shareholders and will ideally reduce agency costs. Thus the incorporation decision is a choice of corporate law. Just as the contractarian theory predicts that charter provisions will be value maximizing, it predicts that a firm will incorporate in the state with a system of corporate law that will maximize its value. As is true of charter terms, the contractarian theory implies that differences in governance needs across firms will lead to some diversity in incorporation choices.

Although not necessary to the contractarian logic, most economics-oriented legal scholars of the 1980s expected states to respond to the demand for corporate law by offering value-maximizing corporate law. The famous incorporation debate that began in the 1970s was framed as a "race" among the states seeking the franchise fees that firms pay to the state in which they incorporate. The dominant view in the 1970s was that states sought to attract incorporations by tailoring their corporate laws to suit management at the expense of shareholders—with little restriction on management discretion and lax protection of shareholder rights. Their logic was simple: managers decide where to incorporate when a firm goes public, and once incorporated in a particular state, managers can keep the firm incorporated there. This view was most prominently advanced in 1974 by William Cary, a former Chairman of the SEC and a professor at Columbia Law School.[47] Three years later, in one of the earliest articles applying economic analysis to corporate law, Winter argued that, contrary to the "almost universal[] . . . opinion of academic commentators," state competition must instead result in a race to the top.[48] Winter argued that manager and shareholder interests coincided in maximizing firm value, because if managers operated a firm at less than maximal value, the firm would be at a disadvantage in raising funds in the capital markets, which would result in weaker performance in the product market and ultimately a hostile takeover in which managers would lose their jobs.[49] Consequently, it would be self-destructive

47. William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 663-68 (1974).

48. Winter, *supra* note 5, at 251.

49. *Id.* at 256.

for management to incorporate in a state with corporate laws that fail to maximize firm value, and self-destructive for a state to adopt such laws.

A corollary of Winter's view, advanced by Barry Baysinger and Henry Butler, was that states would not necessarily run in the same direction in aiming for the "top." Firms, they believed, vary with respect to the sort of corporate law that maximizes their value, and states therefore might design their laws to attract firms of different types.[50] For example, Baysinger and Butler suggested that firms with concentrated ownership would benefit from laws that are strict about management discretion, and firms with dispersed ownership would benefit from lenient laws.[51] Consistent with their general emphasis on diversity in corporate governance needs, Easterbrook and Fischel expressed concern that "[t]here are only fifty states, perhaps too few to offer the complete menu of terms needed for the thousands of different corporate ventures."[52] (Since they thought firms would customize their charters to maximize value, one wonders what potential problem they foresaw in a shortage of default rules.)

The incorporation debate combines three questions that are sometimes blurred. First, when firms go public, do they incorporate in states whose laws are value enhancing, as the contractarian view leads us to expect? Second, once firms are publicly held, do their managers make reincorporation decisions that maximize value? For example, if a state enacts a law that reduces firm value, does management propose reincorporation in another state?[53] Third, what is the nature of the "race" among the states, the suppliers of corporate law? Is it upward or downward? For the most part, the empirical studies of incorporation focus on the last question and address the first two indirectly. The results, however, allow us to draw inferences regarding the first two questions.

Romano undertook the first major empirical analysis of state competition in the market for corporate law.[54] Her study was based on data from public companies reincorporating from one state to another. It did not examine the incorporation decisions of firms going public. Romano found that states adopt innovations in corporate law over time in an S-shaped pattern that resembles the diffusion of innovations in product markets, a pattern that is more generally

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50. Barry D. Baysinger & Henry N. Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431, 456-62 (1985).

51. *Id.* at 459-60.

52. EASTERBROOK & FISCHEL, *supra* note 6, at 216.

53. Reincorporation requires both board and shareholder approval.

54. Romano tracked the fifty states' adoption of eight innovations in corporate law:

> (1) the explicit elaboration of a standard for director and officer indemnification, (2) the exemption from stockholder vote of mergers involving a specified percentage of the corporation's stock, (3) the elimination of appraisal rights in corporations whose shares trade on a national exchange, (4) antitakeover statutes, (5) the right of shareholders to take action nonunanimously without holding a meeting, and the permission to (6) stagger the board of directors, (7) eliminate cumulative voting, and (8) eliminate preemptive rights.

Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 233 (1985).

associated with competitive forces.[55] Romano further found, consistent with the premise that states compete for franchise fees, that a state's responsiveness to corporate law innovations by other states is correlated with its dependence on corporate franchise fees as a source of revenue.[56] Delaware, for which franchise fees comprise a higher proportion of state revenues than they do in any other state, is the most responsive in enacting laws that quickly matched other states' innovations. Interestingly, however, Delaware is not a great innovator.[57]

On the demand side, Romano found that, among public corporations that reincorporate, Delaware is the dominant destination.[58] Furthermore, she found that firms that reincorporate in Delaware are disproportionately firms that plan transactions for which corporate law would be important—for example, mergers or acquisitions, which often attract litigation. She further found that reincorporation in Delaware was associated with an increase in share price.[59] This result is consistent with both earlier and later event studies.[60] It is also consistent with Daines's finding that Delaware firms are valued more highly than firms incorporated elsewhere,[61] a finding that Guhan Subramanian contests.[62]

Romano concluded that state competition in corporate law does, in fact, exist.[63] She explained Delaware's success in terms of self-reinforcing "first-mover advantages" stemming from a number of sources: the importance of franchise taxes to the state budget; a large body of case law; experienced judges; and the familiarity of lawyers nationwide with Delaware law.[64] These findings, however, are somewhat in tension with one another. If Delaware has several first-mover advantages in promoting shareholder interests, and it already held a commanding share of the incorporation market as of the mid-1980s, to what extent do other states try to keep up, let alone overtake Delaware? Why

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55. *Id.* at 233-34.

56. *Id.* at 239-40.

57. *See id.* at 240 (noting that, although Delaware is quick to adopt innovative laws, it is rarely the first to do so).

58. *Id.* at 244.

59. *Id.* at 268-73.

60. *See* Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989); Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259 (1980); Randall A. Heron & Wilbur G. Lewellen, *An Empirical Analysis of the Reincorporation Decision*, 33 J. FIN. & QUANTITATIVE ANALYSIS 549 (1998); Allen Hyman, *The Delaware Controversy—The Legal Debate*, 4 DEL. J. CORP. L. 368 (1979); Jeffry Netter & Annette Poulsen, *State Corporation Laws and Shareholders: The Recent Experience*, FIN. MGMT., Autumn 1989, at 29; Pamela P. Peterson, *Reincorporation: Motives and Shareholder Wealth*, 23 FIN. REV. 151 (1988).

61. *See* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 533-38 (2001).

62. *See* Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 41-44 (2004).

63. Romano, *supra* note 54, at 240.

64. *Id.* at 280-81.

would any firms incorporate in states other than Delaware? If other states do not compete vigorously head-to-head with Delaware, will Delaware get to the "top"? Does the Delaware legislature have slack with which to respond to the lobbying efforts of managers and others whose interests do not necessarily coincide with those of shareholders?

Beginning with a study by Daines,[65] a series of articles published between 2002 and 2006 addressed these questions. The startling finding was that there is no race among the states—to the top or the bottom. Whereas commentators on both sides of the race debate had assumed that all fifty states compete with one another in a national market, these studies found that no such market exists. Instead, nearly all firms incorporate either in their home state (the state in which they are headquartered) or in Delaware. Thus, if there is competition among states it would take the form of each state competing with Delaware for the incorporation of its in-state firms. Daines studied incorporation decisions at the IPO stage. He found that 95% of all firms that went public between 1978 and 2000 incorporated either in their home state or in Delaware, and the states in which most of the remaining 5% incorporated had some other geographical relationship with the firm—for example, the state of incorporation was the state in which the firm was founded or had its former headquarters.[66] Putting Delaware aside, the four most successful states at attracting incorporation by out-of-state firms garnered a total of only 3.5% of firms going public.[67] Consequently, there is little franchise tax revenue at stake for any state other than Delaware.

In an article entitled *The Myth of State Competition in Corporate Law*, Marcel Kahan and Ehud Kamar concluded both that the amount at stake for any state other than Delaware is too small to matter, and that in fact no state other than Delaware takes significant steps to attract incorporations.[68] They base their conclusions on an analysis of states' franchise tax structures, their tax receipts, and the amount of legal business generated by firms incorporated in-state, patterns by which laws are adopted across states, and marketing efforts.[69]

Even if there is no race, all states have corporate law, and firms still choose between incorporation in Delaware or in their home state. What factors influence this decision? Do differences in states' laws drive these choices? Perhaps firms' incorporation decisions can tell us something about the extent to which firms make value-enhancing choices at the IPO stage or thereafter. That is,

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65. Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559 (2002).

66. *Id.* at 1572-74, 1599-1600 ("[A] primary finding of this Article is that the dominant metaphor for state corporate law—a national race to the top or the bottom or a market with 50 producers—is incorrect and potentially misleading. Instead, the market looks more like a series of 49 paired duopolies (or run-offs) between Delaware and other states.").

67. *Id.* at 1573 tbl.4.

68. Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 748-49 (2002).

69. *Id.* at 687-99.

perhaps they can they tell us which way the race would go if states bothered to race.

The fact that geography plays such an overwhelming role in the incorporation decision strongly suggests that the quality of a state's corporate law is *not* an important factor, as the contractarian and race conceptualizations assume. As Daines says, Oregon retains almost 70% of IPO firms headquartered there, but in twenty years only three firms headquartered elsewhere incorporated in Oregon when they went public.[70] If it were the quality of Oregon's corporate laws that led Oregon-based firms to incorporate there, out-of-state firms would presumably see the attraction and incorporate there. Apparently, the attraction lies outside the substantive terms of state law—some factor related to local incorporation itself.

Daines offers two tentative explanations. First, consistent with Coates's finding regarding takeover defenses in charters, he finds that lawyers have influence. Daines finds an association between the use of local law firms by companies going public and in-state incorporation.[71] Second, Daines finds evidence that firms concerned about future takeovers tend to incorporate in state. His explanation is that they may find favor in the state legislature or in the courts when they seek to ward off hostile bidders.[72] Lucian Bebchuk and Alma Cohen also find evidence that in-state incorporation is motivated by a desire to influence future corporate law.[73] They find that while large firms generally incorporate in Delaware, large firms headquartered in small states tend to incorporate in state. They infer that large firms that incorporate in small states expect to have influence over future changes in corporate law.[74] Neither of these explanations is encouraging from the perspective of the contractarian theory.

Using data on incorporation patterns of firms that are already public, Bebchuk and Cohen,[75] as well as Subramanian,[76] report evidence that states with antitakeover statutes retain more in-state firms than do states without such statutes—a result that would be very much at odds with both contractarian theory and the race-to-the-top proposition. Kahan, however, disputes this claim. He finds that the quality of a state's courts and certain elements of flexibility in a state's corporate law play a role in retaining in-state incorporation and that,

70. Daines, *supra* note 65, at 1576.

71. *Id.* at 1599-1600.

72. *Id.* at 1590. In another study, Romano finds that state antitakeover statutes were generally enacted at the behest of managers or in-state firms that were the object of hostile takeover attempts. Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 122-23 (1987).

73. Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 402 (2003).

74. *Id.* at 398-403.

75. *Id.* at 404-20.

76. Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1846, 1852-53 (2002).

when these factors are included in a model, state antitakeover statutes become insignificant.[77]

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In sum, the empirical work on state competition has yielded results that differ substantially from what the contractarian theory implied—both with respect to whether states race for incorporations and whether firms at the IPO stage make incorporation choices based on the quality of state law.

Regarding the race among the states, it may have occurred at one time, but by the time of the debate the race was over and Delaware dominated the market. Since Delaware does not operate in a competitive environment, there is no way to evaluate whether its legal rules are at the "top." Nevertheless, there is evidence that Delaware incorporation is value enhancing—as a result of perceived competition or the culture surrounding the production of corporate law in Delaware.

The value of Delaware incorporation may come from the substance of its legal rules. But it comes from other sources as well. An obvious source of value is the volume of Delaware case law, and the expectation that this volume will continue to grow. A high volume of case law, which admittedly is difficult to separate fully from the quality of case law, can reduce legal uncertainty and thereby enhance firm value. The value of Delaware incorporation may come as well from lawyers' familiarity with Delaware law and the ease with which they can provide reliable legal advice. And of course the expertise of the Delaware judiciary, which is closely tied to the quality of its substantive law, is a source of value to firms incorporated there.

These sources of value all stem from the same network externality dynamic described above with respect to the attraction of default rules over innovation and customization—a dynamic that is entirely different from the race that Winter originally envisioned.[78] Indeed, the quality of the law itself is in part a result of network externalities. As more firms incorporate in Delaware, the expected volume of case law increases, lawyers' familiarity with Delaware law increases and diffuses through the profession, and the Delaware judiciary gains more experience and more exposure to contemporary business practices, which in turn will attract more leading lawyers to the Delaware judiciary. These effects then

77. Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?*, 22 J.L. ECON. & ORG. 340, 363-64 (2006).

78. *See supra* text accompanying note 46. Several years after his pathbreaking article, Winter revised his views regarding the race to the top, which he recharacterized as a "leisurely walk." He saw state antitakeover statutes as potentially retaining firms, even if those statutes are not value maximizing. He also saw that Delaware only has to stay slightly ahead of the competition. And he recognized that state legislatures might not be motivated solely by franchise taxes. *See* Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526, 1528-29 (1989).

feed back into the value of Delaware incorporation, which continues to attract incorporations.[79]

With respect to whether firms make value-maximizing incorporation decisions, the fact that most firms at the IPO stage incorporate in Delaware implies that many do. This is consistent with the contractarian theory. On the other hand, management reaps personal benefits from Delaware law—legal certainty and clear legal advice, for example—and there is no apparent tension between managers' personal benefits and shareholder interest in making the decision to incorporate in Delaware. Widespread Delaware incorporation, therefore, is weak support for the contractarian theory regarding value maximization at the IPO stage. Moreover, the fact that a substantial minority of firms incorporate in their home states, apparently without regard to the content of state law, suggests that market pressure to maximize firm value, if it exists, is not strong.

III. Governance Adjustments Once a Company Goes Public: The "Midstream" Stage

Once a company goes public, the characterization of changes in the manager-shareholder relationship as "contractual" is weaker than at the IPO stage. A charter amendment requires, first, approval by the board of directors and then approval by shareholders. The board must initiate the amendment. Shareholders cannot. In addition, the board can make substantial changes to a company's governance structure unilaterally—for example, it can adopt a poison pill or change executive compensation. In the foreword to a widely read issue of the *Columbia Law Review* in 1989, Bebchuk stated: "[t]he debate on contractual freedom in corporate law should be viewed as two debates, not one. The questions of contractual freedom in the initial charter and in midstream (that is, after the corporation has been formed and its initial charter set) are different and require separate examination."[80] In the same issue, Easterbrook and Fischel acknowledged that "[t]he difference between governance provisions established at the beginning and provisions added later suggests some caution in treating the two categories alike."[81]

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79. *See* Oren Bar-Gill, Michal Barzuza & Lucian Bebchuk, *The Market for Corporate Law*, 162 J. INSTITUTIONAL & THEORETICAL ECON. 134, 151-52 (2006); Klausner, *supra* note 19, at 846-47; Romano, *supra* note 54, at 277.

80. Bebchuk, *supra* note 10, at 1399.

81. Easterbrook & Fischel, *supra* note 9, at 1443. In other articles, many of which were included in the symposium issue, legal scholars spelled out the weaknesses of the contractarian arguments at the midstream stage. Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703 (1989); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989); *see also* Lucian Arye Bebchuk, *Limiting Contractual*

Contractarians nonetheless advocated private ordering in what became known as the "midstream stage." They supported their position on two bases. First, they assumed that IPO charters would contain provisions that limit changes in the corporate contract—for example, restrictions on poison pills—that would reduce firm value.[82]

Second, some argued that market forces would encourage boards to initiate governance arrangements that enhance firm value.[83] Here there was some division in the ranks of the contractarians. Easterbrook and Fischel believed that the value-maximizing response to a takeover bid was for management to remain passive and allow the shareholders to tender their shares to the acquirer if they chose to, and they were doubtful that charter provisions could constrain management to remain passive. They thus were inclined toward a mandatory legal rule requiring management to remain passive in the face of a hostile bid.[84] David Haddock, Jonathan Macey, and Fred McChesney disagreed. They argued that market forces would induce management to adopt value-maximizing contractual arrangements in advance that would govern responses to hostile bids.[85] Though not specific regarding the market mechanism that would provide such discipline, they expressed this faith based on "overwhelming empirical evidence from various aspects of corporate governance [that] suggests that faithful managers are rewarded while the faithless are punished."[86]

The contractarian claims for the midstream stage raise two empirical questions: First, do IPO charters include provisions limiting midstream governance changes that favor managers at shareholders' expense? Second, after a company goes public, does management tend to initiate value-enhancing governance changes, and in particular does it do so with respect to takeover defenses?

Prior studies of IPO charters provide a negative answer to the first question. IPO charters do not constrain management's initiation of governance changes. Coates reports that there was no prohibition on poison pills in the

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Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 HARV. L. REV. 1820, 1848 (1989).

82. *See* EASTERBROOK & FISCHEL, *supra* note 6, at 33 ("[T]he rules for amending the rules are themselves part of the original articles, and it is (or should be) possible to draft limitations on amendment."); *see also* Haddock et al., *supra* note 8, at 727-28.

83. *See, e.g.*, Baysinger & Butler, *supra* note 50, at 448-51.

84. EASTERBROOK & FISCHEL, *supra* note 6, at 167-74.

85. Haddock et al., *supra* note 8. In their original article on management responses to hostile takeovers, Easterbrook and Fischel advocated for a mandatory legal rule of passivity. Easterbrook & Fischel, *supra* note 25, at 1164. In their book, ten years later, they remained doubtful that a contractual approach would work, but softened their position, advocating instead for a default rule that would require passivity. EASTERBROOK & FISCHEL, *supra* note 6, at 174 ("[T]he optimal legal rule prevents resistance unless expressly authorized by contract *ex ante*.").

86. Haddock et al., *supra* note 8, at 737. In another article, Macey and McChesney state: "The 'market for managers' penalizes management teams who try to advance their own interest at shareholders' expense." Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13, 40 (1985).

charters that he sampled.[87] Daines and I also found that no charter in our sample prohibited poison pills, subjected them to shareholder approval, or otherwise limited management's authority to adopt a poison pill.[88] Since shareholders actively opposed managements' unilateral adoption of poison pills during the time period covered by our sample, it is not plausible that the complete absence of restrictions in IPO charters reflected the market's acceptance of them as value enhancing.[89] Furthermore, in contrast to the contractarian expectation, charters commonly contain provisions that deter *shareholders* from amending bylaws—for instance, with supermajority vote requirements.[90] Regarding the second question—management initiation of governance changes—empirical studies as well as casual observation reveal a dynamic between shareholders and management that falls far short of the invisible hand inducing management to initiate agency-cost-reducing governance arrangements. The dynamic instead is one in which shareholders exert pressure on management, and management either acquiesces or does not. Battles between shareholders and managers have continued, often over the same issues, for three decades.

A. *Corporate Governance from the Mid-1980s to the Mid-2000s*

From the late 1980s until the mid-2000s, shareholders and managers battled primarily over two governance issues: takeover defenses and the independence of the board.[91] Shareholder proposals to redeem poison pills or to subject them to shareholder approval received substantial and increasing support throughout this period, as did shareholder proposals to destagger boards.[92] Nonetheless, management declined to accede to either demand, arguing that both poison pills and staggered boards were beneficial to shareholders in that they enhanced the bargaining power of target management once a takeover bid was made. In fact, early in this period, management of some firms sought

87. Coates, *supra* note 28, at 1357. He found that only 4% of companies had insufficient authorized preferred or common shares to create a poison pill. *Id.* That, however, did not necessarily reflect a prohibition on poison pills and could have been reversed if the company sought shareholder approval for additional authorized shares for another purpose.

88. Daines & Klausner, *supra* note 16, at 95. The charters that I surveyed for this Essay also contained no limitations on charter amendments favoring management.

89. Michael Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755, 757-58 (2003).

90. Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 146 (2003). This data is not taken from IPO charters, but there is no reason to believe that shareholders would have adopted such provisions midstream.

91. Georgeson, a provider of strategic shareholder consulting services, has made available online a series of annual reports that provide a useful chronology of shareholder proposals. *See Annual Corporate Governance Review*, GEORGESON, http://www.georgeson.com/us/resource/Pages/acgr.aspx (last visited June 9, 2013).

92. Klausner, *supra* note 89, at 757-62.

shareholder approval of charter amendments that would stagger as-yet unstaggered boards.[93]

Management was less resistant with respect to increasing the (formal) independence of the board. In response to shareholders' concerns, the percentage of independent directors on boards increased substantially, as did the number of firms that separated the CEO and board chair positions.[94]

Whether takeover defenses and independent boards tend to enhance value are empirical questions. This Subpart reviews what we have learned regarding the value of each. It also reviews and corrects some misunderstandings that have been reflected in the empirical literature on takeover defenses since the early years of these studies. On the whole, the experience of the period from the mid-1980s to the mid-2000s does not support the contractarian expectation that management will initiate agency cost-reducing measures.

1. *Takeover defenses*

Empirical research has long documented the fact that target shareholders reap substantial gains from hostile acquisitions.[95] Takeover defenses, therefore, have the potential to reduce target shareholder value if they deter bids or allow management to defeat them. Moreover, if managers feel less pressure from the takeover threat to maximize share value on an ongoing basis, then shareholders may be worse off even in the absence of an actual takeover. On the other hand, if management uses a takeover defense to force a bidder to negotiate a higher price or to resist bids at too low a price, then the presence of the measure could promote shareholder value in firms that receive bids. The same defenses in the hands of different managers can either reduce or enhance shareholder value. The impact of takeover defenses is therefore an empirical question.

The remainder of this Subpart reviews what we have learned—and what we have not—from the empirical literature about poison pills, staggered boards, and other defenses. It can all be summarized quite simply:

- Although poison pills are one of only two important antitakeover mechanisms, empirical analysis cannot tell us anything about their causal impact on takeover likelihood or firm value.

93. *Id.* at 758 & n.7, 759 tbl.2.

94. *See infra* Part III.A.2.

95. For summaries of studies that show this, see Gregor Andrade et al., *New Evidence and Perspectives on Mergers*, J. ECON. PERSP., Spring 2001, at 103; Sanjai Bhagat et al., *Hostile Takeovers in the 1980s: The Return to Corporate Specialization*, BROOKINGS PAPERS ON ECON. ACTIVITY, no. 1, 1990, at 1; Gregg A. Jarrell et al., *The Market for Corporate Control: The Empirical Evidence Since 1980*, J. ECON. PERSP., Winter 1988, at 49; and Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983). Although acquirers' gains are small and sometimes negative, the research summarized in these articles has also shown that total gains to the shareholders of the target and the acquirer are large.

- A staggered board is the only other important takeover defense, and empirical studies have generally shown that it is associated with reduced share value. Whether the evidence proves a causal relationship is subject to some dispute, but in my view an inference of causation is supported.
- Nearly all other takeover defenses that have been studied empirically became irrelevant in 1985, when the Delaware Supreme Court upheld the use of the poison pill. At the margin, alternative measures can have no causal impact on takeover exposure or firm value.
- The fact that boards refused to destagger during the period from the mid-1980s to the mid-2000s appears to be inconsistent with value-maximizing behavior. This interpretation of the data is supported by positive share price reactions when, boards began to destagger in the mid-2000s.

Much of this Subpart is written with an economist readership in mind—specifically, the explanations of takeover defenses. Ever since the 1980s, the finance literature on takeover defenses has reflected substantial misconceptions regarding how defenses work. I clarify some of those misunderstandings in this Subpart. In Part IV, I return to this topic, focusing on misconceptions reflected in the recent use of governance indices. My intent is to promote better modeling of the legal institutions involved.

a. *Poison pills*

A poison pill, formally known as a "shareholder rights plan," prevents a takeover from proceeding until the target board of directors disables it. The pill's Rube Goldberg details are unimportant, but the basic mechanism is to massively dilute the shares of a would-be acquirer when the acquirer's shareholding crosses a specified threshold—for example, 20% of outstanding shares. A company's board can unilaterally adopt a poison pill at any time. No shareholder approval is needed. It can adopt a pill in the heat of a takeover attempt or in advance, when there is no takeover on the horizon. If a bid is made, a board can keep the pill in place while it tries to negotiate a higher price or to attract a competing bid.[96] Alternatively, a board can simply reject a bid and keep the pill in place—in the takeover parlance, it can "just say no."[97] While the pill is in place, the acquisition will not proceed, but the board can choose to disable it.

96. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (upholding the use of a poison pill where no bid is imminent).

97. *See* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989) (upholding management's use of a poison pill to reject a hostile offer because it was inconsistent with long-term business strategy).

If a board uses a pill to just say no, the takeover effort is not dead. The acquirer can still go directly to the target's shareholders and give them the opportunity to replace their board with one that will disable the pill and allow the bid to proceed. The acquirer does so through a proxy contest in which it asks target shareholders to remove the current board and elect a slate of directors whom the bidder has nominated. Depending on the presence or absence of certain charter and bylaw provisions discussed below, completing a proxy contest takes at least a few months. If a target company has a staggered or "classified" board, it can take a bidder over two years to replace a majority of the target's board and allow a takeover to proceed. A staggered board, which I discuss in the next Subpart, can therefore pose a substantial barrier to a hostile acquirer.

If a target company does not have a staggered board, the time it will take to replace its board depends on a number of factors.[98] The most important factor is whether the target's charter allows shareholders to call a special meeting or to vote by written consent.[99] Either of these two avenues allows shareholders to elect directors at any time. If a firm's charter blocks these avenues of shareholder action, then the acquirer must wait up to roughly one year before proceeding at the next shareholder's meeting.

Between 1986 and 1996, twelve event studies were published on the impact that poison-pill adoption had on share value.[100] There is, however, an inherent problem with each study—and with *any* effort to measure the impact of the adoption of a poison pill. As stated above, a poison pill can be adopted unilaterally at any time by a board of directors. If a firm does not have a pill today, it can have one tomorrow (or even later today), and it certainly will have a pill if it receives a bid that it does not want to accept immediately. One study found that among targets of hostile takeover attempts, every company either had a pill in advance or adopted a pill once a takeover bid was made.[101] Thus, while a pill may ultimately have a causal impact on share value when a takeover bid is made, the absence of a pill in the meantime does not have a causal impact. Consequently, the adoption of a pill is a nonevent, and an event study will not measure its impact. Coates made this point in a critique of the finance literature as of 2000.[102]

Not surprisingly, the results of pill-adoption event studies ranged from finding no significant abnormal returns to finding statistically significant but

98. Coates describes these in detail. *See* Coates, *supra* note 28, app. B.

99. *See* DEL. CODE ANN. tit. 8, §§ 211(d), 228(a) (2013).

100. *See* John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271 app. A (2000) (listing the results of these studies).

101. *See* Lucian Arye Bebchuk, John C. Coates & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 926-27 (2002).

102. Coates, *supra* note 100, at 286-91.

economically small returns, both negative and positive.[103] The studies that found a statistically significant negative effect on share prices were those that used the earliest sample period.[104] Robert Comment and William Schwert's study, which was the largest at the time, found statistically significant negative effects only in 1984 (when nine pills were adopted).[105] As the authors suggested, this may reflect the market's initial lack of understanding regarding how the pill would work.[106] Later studies generally found no statistically significant result. Coates pooled all event studies of poison pills and found that the weighted average price reaction to the adoption of a poison pill, using either a two-day or a three-day event window, was a 0.02% increase.[107]

A recent study by Martijn Cremers and Allen Ferrell found that after 1985, the year in which the Delaware Supreme Court upheld the use of a poison pill, firms that adopted poison pills had lower value (measured by Tobin's Q) than did firms that had not adopted pills.[108] Since any firm can adopt a pill at any time (and many did over the course of their study), it cannot be the adoption itself that is causing this difference in value. Instead, the cross-sectional differences they find must reflect something about companies that adopt poison pills on a standby basis compared to companies that wait until a bid is made, or that waited past the end of their sample period. It may be that lower-value companies choose to adopt pills on a standby basis and higher-value companies wait. It is tempting—and not inconsistent with the causal point made here—to infer that the adoption of a standby pill is a signal of management's plan to resist a takeover bid if one arises. But if that were true, event studies would have shown a negative abnormal return upon adoption.

b. *Staggered (or "classified") boards*

In order to evaluate management's insistence on maintaining a defense against hostile takeovers, one must focus on staggered boards and determine their impact on share value. A staggered board is a board on which directors serve three-year terms, and a third of the board stands for election each year. If a board is staggered, it takes two shareholder elections at consecutive annual meetings to replace a majority of its directors. In combination with a poison

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103. *See id.* at 280-86 (summarizing results of pill studies).

104. *Id.* at 284 ("Studies of early pill adoptions show (weak) negative results, whereas the only studies of pill adoptions after 1986 show no statistically significant results for their full samples.")

105. Robert Comment & G. William Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, 39 J. FIN. ECON. 3, 20 tbl.2, 21 (1995).

106. Comment & Schwert, *supra* note 105, at 21.

107. Coates, *supra* note 100, at 283.

108. Martijn Cremers & Allen Ferrell, Thirty Years of Shareholder Rights and Firm Valuation 19-20 (May 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1413133.

pill, a staggered board can therefore delay a would-be bidder for roughly two years. Other than dual-class stock, which is rarely used, a staggered board is the most powerful takeover defense available. If a firm has a staggered board, no other defense is relevant—it will have no appreciable impact.[109]

As explained above, a poison pill allows a board to resist a takeover bid indefinitely. A bidder's response, therefore, is to give target shareholders an opportunity to replace their board with a new one that will disable the poison pill. If the target has an annually elected board, its board can be replaced in a single shareholder vote. Depending on whether a target's charter or bylaws allow for a shareholder vote between annual meetings—at a special meeting or by written consent—the vote can take place between a few months and a year following the beginning of the takeover effort. If, however, the target has an "effective" staggered board, two shareholder elections must occur at two consecutive annual meetings in order to replace a majority of the target's board.[110] Depending on when an acquisition begins in relation to the target's next annual meeting, and on whether there are other applicable restrictions on nominating directors at the next meeting, this can take up to two years, or even slightly longer.

A two-annual-meeting delay makes it difficult for a would-be acquirer to make a bid. If the acquirer makes a formal unconditional bid, it takes a risk that circumstances will change over the period in which it is waiting for the second shareholder vote. Not only might exogenous conditions change, but the target's

109. Prior to the advent of the poison pill, a staggered board did not pose a significant barrier to a takeover. It was possible for target directors to remain in their positions for one or two years after a takeover was completed, but there would be no personal benefit to their doing so once a hostile acquirer was in control.

110. Research into the effect of a staggered board as a takeover defense should be limited to effective staggered boards. For a more detailed explanation of the differences between effective and ineffective staggered boards, see Bebchuk et al., *supra* note 101, at 890, 893-95. An "effective" staggered board is a staggered board that will prevent target shareholders from electing a majority of the target board in a single election. The primary example of an "ineffective" staggered board is one that is provided for in a company's bylaws rather than in its charter. Whereas an incumbent board must agree to amend a charter, shareholders can unilaterally amend a company's bylaws. Consequently, if shareholders want to allow an acquisition to occur, they can vote to amend the bylaws to convert the board to an annually elected board and then elect the acquirer's nominees to replace the incumbent board—all at the same meeting. *Id.* at 898. Although most staggered boards are provided for in a company's charter, some are provided for in bylaws. *See* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 419 (2005). When a staggered board is provided for in a company's bylaws, it does not function as a takeover defense unless a substantial supermajority vote of the shareholders is required to drop it from the bylaws. Other ways in which a staggered board can be ineffective as a takeover defense are (1) where a company's charter allows shareholders to expand the size of the board enough to create a sufficient number of vacancies so that an acquirer's nominees will constitute a majority of the board and (2) where a company's charter and the law of the state in which it is incorporated allow shareholders to remove a staggered board's directors without cause. Bebchuk et al., *supra* note 101, at 894. For the remainder of this Essay, except where the distinction between an effective and ineffective staggered board is relevant, I will simply use the term "staggered board" to refer to an effective staggered board.

management may cause circumstances to change—for example, by selling a portion of the business that the bidder wants. Conversely, if the would-be acquirer does not make an unconditional bid, target shareholders may not take its initial proxy contest seriously and may decline to elect its nominees to the board. Electing the bidder's nominees for one-third of the board would mean having a divided board for a year, which may not be good for the ongoing management of the company.[111]

For these reasons, as an a priori matter, there is reason to believe that a staggered board can be detrimental to share value. A staggered board allows management, if it chooses, to resist an acquisition that is in the interests of shareholders. Second, with this protection from the takeover threat, management may feel less pressure to perform and thus may fail to maximize share value on an ongoing basis. On the other hand, in the hands of a diligent and loyal management team motivated by other factors, a staggered board can be used to enhance a target's bargaining power in order to extract a higher price from an acquirer. Thus, the question whether a staggered board is good or bad for shareholders is an empirical one.

Despite the fact that economists had been studying takeover defenses of various sorts since the 1980s, the first empirical study of staggered boards was not published until 2002 (by law professors). This study, by Bebchuk, Coates, and Subramanian, found that staggered boards had a negative impact on shareholder value.[112] The authors found that companies with staggered boards were more likely to remain independent, and that remaining independent meant lower returns to shareholders as compared with companies that were acquired. They further found that when targets with staggered boards were sold, the premiums they commanded were not statistically different from those of firms without staggered boards. The result of these impacts together meant an average loss of 8% to 10% in share value.[113] In another study, Bebchuk and Cohen directly compared the value of companies with and without staggered boards and confirmed this conclusion, finding that staggered boards were associated with lower firm value (as measured by Tobin's Q) than firms with annually elected boards.[114]

For the most part, these findings have been confirmed and refined by later studies. One study found that the direct cost of staggered boards in terms of the expected value of shareholders' gain from takeovers is less than what Bebchuk et al. and Bebchuk and Cohen found.[115] Others have found evidence of lost value due to managerial slack created by insulation from the threat of a hostile

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111. *See* Bebchuk et al., *supra* note 101, at 919-24.

112. *Id.* at 890-91.

113. *Id.* at 938-39.

114. Bebchuk & Cohen, *supra* note 110, at 410.

115. Thomas W. Bates et al., *Board Classification and Managerial Entrenchment: Evidence from the Market for Corporate Control*, 87 J. FIN. ECON. 656, 671, 673-75 (2008).

takeover. That slack has been documented with respect to failing to fire poorly performing CEOs[116] and making value-destroying acquisitions.[117] Finally, a recent study has made use of a natural experiment produced by court rulings involving a staggered board to show a causal relationship between staggered boards and reduced firm value—that staggered boards cause firms to have lower value, as opposed to management of lower-value firms choosing to protect themselves with staggered boards.[118] The results of this study not only confirm prior findings that staggered boards are associated with lower firm value; it also supports a causal inference.

c. *Other takeover defenses*

Since 1985, a staggered board and poison pill have been the only takeover defenses that matter.[119] A staggered board matters, as explained above, because it can impede the efforts of a would-be acquirer to replace a target board in order to disable the target's poison pill. Even without a staggered board, the poison pill has rendered essentially all other defenses irrelevant—including business combination provisions, fair price provisions, control share acquisition provisions, and others.[120] This is true whether the defense is in a firm's charter

116. *See* Olubunmi Faleye, *Classified Boards, Firm Value, and Managerial Entrenchment*, 83 J. FIN. ECON. 501, 522-26 (2007).

117. *See* Ronald W. Masulis et al., *Corporate Governance and Acquirer Returns*, 62 J. FIN. 1851, 1853, 1867-69 (2007).

118. Alma Cohen & Charles C.Y. Wang, *How Do Staggered Boards Affect Shareholder Value? Evidence from a Natural Experiment* 1, 3-4 (Harvard Bus. Sch., Working Paper No. 13-068, 2013), *available at* http://ssrn.com/abstract=2141410.

119. Dual-class stock is the other antitakeover defense that can have an impact, but it is rarely present. It is also possible that a combination of a prohibition on shareholder voting by written consent coupled with a prohibition or severe restriction on the ability of shareholders to call a special meeting could deter takeovers. If both these limitations on shareholder voting are present, an acquirer must wait until the target's next annual meeting to mount a proxy contest to replace the board. This delay is not as severe as the delay created by a staggered board, but it still could be meaningful.

120. Because this is an area that remains subject to confusion in the finance literature, I have left the statement in the text in unqualified form. (I also repeat it multiple times.) Some qualification, however, is technically appropriate, though not of practical significance in evaluating the literature. One qualification is that while the Delaware Supreme Court upheld the use of the poison pill in 1985, other state courts had yet to follow. At that point, other defenses became irrelevant in Delaware. But if one wanted to study antitakeover charter amendments in firms incorporated outside of Delaware, studying defenses other than staggered boards would have been justifiable. This would have been an exercise of short-lived utility, however, since all states before long accepted the poison pill. Also, since many states follow Delaware's lead, the market may well have expected all states to approve the use of the pill. No study has isolated the effect of other defenses in states that had not validated poison pills. A second, and less important qualification is that it was not until the Delaware Supreme Court's decision in *Time*, 571 A.2d 1140 (Del. 1989), that it became clear that a target board could keep a pill in place indefinitely to prevent an acquisition from occurring. So perhaps other defenses might have had some impact until this became clear. But just as a pill

or in a state statute. Because the poison pill dominates other defenses, and because a board can adopt a pill unilaterally, the presence or absence of other defenses is of no consequence to a company's exposure to a hostile acquisition.[121]

Due to a lack of understanding regarding how each takeover defense works, however, many studies of the late 1980s and 1990s focused on these other defenses. In his critical review of empirical studies of takeover defenses, Coates stated: "If pill studies suffered from the failure of researchers to realize that poison pill adoptions do not affect a firm's legal takeover vulnerability, shark repellent studies have been unhelpful because research has focused on the wrong types of shark repellents."[122] (The term "shark repellent" was used in the 1980s and 1990s to refer to antitakeover defenses adopted in a firm's charter.)

The empirical studies of takeover defenses that economists published in the late 1980s and 1990s suffered from two flaws. First, some used sample periods that either predated the advent of the poison pill in 1985[123] or that spanned that year.[124] Prior to 1985, takeover defenses, including staggered boards, were weak deterrents to a hostile takeover, but they were all target management had available to make an acquisition less attractive. Studies of the impact of pre-poison-pill defenses during the pre-poison-pill era are therefore of interest only as a historical matter. Second, once state courts and legislatures validated the

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could be left in place or disabled by a target board, so too could most other defenses. If a court were to hold that a pill could not be kept in place indefinitely, it would have taken the same position with respect to other defenses, since the governing principles of fiduciary duty would be the same. Therefore, even between 1990 and 1995, there was no basis for viewing other defenses as more protective than a pill in any respect.

121. Pre-pill takeover defenses included fair price provisions and provisions requiring a supermajority vote to approve a merger. These defenses were not defenses against takeovers per se. They were defenses against two-tiered, front-end-loaded tender offers, which created pressure for shareholders to tender their shares even if they thought the price was not right. Once the poison pill became available to defend against these tender offers, the presence or absence of other provisions became irrelevant. The ability of the poison pill to deter such tender offers is reflected in the fact that such bids essentially disappeared after the late 1980s, as did these putative defenses. For a more detailed explanation, see Coates, *supra* note 100, at 320-25.

122. *Id.* at 320.

123. *See, e.g.*, Gregg A. Jarrell & Annette B. Poulsen, *Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980*, 19 J. FIN. ECON. 127 (1987); Victoria B. McWilliams, *Managerial Share Ownership and the Stock Price Effects of Antitakeover Amendment Proposals*, 45 J. FIN. 1627 (1990); John Pound, *Proxy Contests and the Efficiency of Shareholder Oversight*, 20 J. FIN. ECON. 237 (1988).

124. *See, e.g.*, Brent W. Ambrose & William L. Megginson, *The Role of Asset Structure, Ownership Structure, and Takeover Defenses in Determining Acquisition Likelihood*, 27 J. FIN. & QUANTITATIVE ANALYSIS 575, 577, 586 (1992); Kenneth A. Borokhovich et al., *CEO Contracting and Antitakeover Amendments*, 52 J. FIN. 1495 (1997); James M. Mahoney & Joseph T. Mahoney, *An Empirical Investigation of the Effect of Corporate Charter Antitakeover Amendments on Stockholder Wealth*, 14 STRATEGIC MGMT. J. 17 (1993); Victoria B. McWilliams & Nilanjan Sen, *Board Monitoring and Antitakeover Amendments*, 32 J. FIN. & QUANTITATIVE ANALYSIS 491 (1997).

use of the poison pill, the only studies of takeover defenses that would be of value were studies of staggered boards. Other defenses had become irrelevant. Many studies of the late 1980s and 1990s, however, combined staggered boards with other (obsolete and therefore irrelevant) defenses into a single variable representing the presence of a takeover defense.[125] Their results are therefore of questionable value.

The confusion among economists in the 1980s and 1990s regarding how takeover defenses worked, and the concomitant inconsistencies in research design, produced conflicting results—and continued efforts to resolve the conflicting results, without understanding the takeover defenses themselves.[126] Current articles continue to refer to the conflicting results of the 1980s and 1990s as a puzzle that can somehow be resolved with a study today of staggered boards in the post-pill era.[127] The confusion thus continues. In an effort to dispel the current confusion, I explain takeover defenses further in Part IV with respect to governance indices.

2. *Board independence*

In contrast to the experience with staggered boards, management acceded to shareholder demands to increase the number of outside directors on boards and, to some extent, to separate the positions of CEO and board chair. From 1950 to 2005, the percentage of independent directors on boards rose from approximately 35% to 70%.[128] While earlier in the century, separating the position of CEO and board chair was uncommon, from 1992 to 2002, the percent-

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125. *See, e.g.*, Ambrose & Megginson, *supra* note 124, at 584, 585 tbl.4, 586 (combining staggered board and obsolete defenses and using sample period that spans 1985); Borokhovich et al., *supra* note 124, at 1497, 1499, 1508 tbl.III (same); McWilliams & Sen, *supra* note 124, at 494-95 (same).

126. *See, e.g.*, Borokhovich, *supra* note 124, at 1502-03 (referring to the number of takeover defenses as relevant to takeover protection); McWilliams & Sen, *supra* note 124, at 491-92 (reflecting lack of awareness concerning how each defense works and how differences should be reflected in prior results).

127. For example, Olubunmi Faleye, in framing his 2007 study of staggered boards, refers to two studies in the 1980s and 1990s that reached opposite results. Faleye, *supra* note 116, at 502. As indicated above, Faleye's study is one of the most illuminating of all studies of staggered boards. Nonetheless, as is evident in other studies, he misunderstands the operation of a staggered board in combination with other governance mechanisms. For instance, he refers to a combination of a staggered board with limits on the power of shareholders to call special meetings or to vote by written consent. *Id.* No such combination exists; staggered boards require votes at annual meetings. He also tests for an association between staggered boards and state antitakeover statutes. *Id.* For reasons explained above, such associations are not relevant to the ability of a target board to resist a hostile takeover. *See supra* Part III.A.1.c.

128. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1474 fig.1 (2007).

age of companies with independent board chairs rose from 20% in 1992 to 25% in 2002.[129]

From a contractarian perspective, two aspects of the period from the mid-1980s to the mid-2000s were interesting. First, changes in board independence were not management-initiated efforts to bond themselves to shareholder interests. There were instead accessions to shareholder demands—some long-standing. Second, the governance changes that were adopted were not contractual. They were made as a matter of practice, with no commitment in firm charters to maintain them. The contractarian theory did not posit that all governance would be explicitly contractual, so there is not necessarily an inconsistency here. On the other hand, this suggests that there may be impediments to making legally binding commitments than the contractarians did not recognize.

Interestingly, the results of empirical studies of board independence and separation of CEO and board chair positions are at best mixed with respect to whether they promote shareholder interests. With respect to board independence, studies have found that independent boards do well at performing discrete tasks such as firing poorly performing CEOs, responding to takeover bids, and making takeover offers.[130] Nonetheless, studies generally find insignificant relationships between board independence and accounting performance, firm value, and long-term stock market performance.[131] In light of endogeneity issues, omitted-variable bias, and the noise always inherent in cross-sectional data, however, these results do not necessarily rule out the possibility that independent boards have an impact on firm value.

Benjamin Hermalin and Michael Weisbach, in reviewing the literature on independent directors, conclude that there is little evidence that the percentage of independent directors on a board increases firm value.[132] While there is evidence that a CEO who holds the position of board chair has more power than one who does not, and is less likely to be replaced when the firm does poorly, the causal direction of this relationship is ambiguous. It is possible that a

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129. SPENCER STUART, SPENCER STUART BOARD INDEX 10 (2012), *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/Spencer-Stuart-US-Board-Index-2012_06Nov2012.pdf; B. Ram Baliga et al., *CEO Duality and Firm Performance: What's the Fuss?*, 17 STRATEGIC MGMT. J. 41, 43 (1996).

130. *Cf.* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 924, 928, 932 (1999); Gordon, *supra* note 128, at 1465, 1500-05.

131. *See* Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L. ECON. & ORG. 101, 101-04 (1985).

132. For a summary of this literature, see Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, FED. RES. BANK N.Y. ECON. POL'Y REV., Apr. 2003, at 7, 12.

powerful or successful CEO is more likely to be given the chair position than a less powerful and less successful CEO.[133]

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In sum, prior to the mid-2000s, management maintained staggered boards despite shareholder pressure to dismantle them, and the empirical evidence indicates that doing so was, on average, value decreasing. This suggests that market pressure on management to maximize share value is not as strong as Haddock et al. believed. On the other hand, management did accede to shareholder demands that it increase the independence of boards. It is unclear, however, whether this was a value-increasing measure. When compared with what Kahan and Rock would later call the "substantive" independence of directors beginning in the mid-2000s,[134] one wonders whether the market was justifiably doubtful that a putatively independent director, or even an independent board chair, would promote shareholder interests when they conflicted with the interests of the CEO.

B. *Corporate Governance Since the Mid-2000s*

In the wake of the Enron and WorldCom scandals of the early 2000s and the passage of the Sarbanes-Oxley Act in 2002,[135] the corporate governance environment changed dramatically. In *Embattled CEOs*, Marcel Kahan and Edward Rock describe these changes and their impact on corporate governance.[136] Some of the changes were legal. Sarbanes-Oxley required stock exchanges to adopt standards for director independence—what Kahan and Rock refer to as "nominal" independence.[137] Sarbanes-Oxley also required independent directors to meet at least once a year in executive session without the CEO present, and to name a director to lead those sessions.[138] In many companies, the result has been the establishment of an ongoing position of lead director.[139]

133. For a survey of this literature, see Renée B. Adams et al., *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 J. ECON. LIT. 58, 82 (2010).

134. Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1025-33 (2010).

135. Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

136. Kahan & Rock, *supra* note 134, at 1007-33.

137. *See* Order Approving NYSE and NASDAQ Proposed Rule Changes Relating to Equity Compensation Plans, Exchange Act Release No. 48,108, 68 Fed. Reg. 39,995 (July 3, 2003).

138. *See* NASDAQ STOCK MARKET RULES § 5605(b)(2) (2013); NYSE LISTED COMPANY MANUAL § 303A.03 (2013).

139. DAVID LARCKER & BRIAN TAYAN, CORPORATE GOVERNANCE MATTERS: A CLOSER LOOK AT ORGANIZATIONAL CHOICES AND THEIR CONSEQUENCES 136-39 (2011).

Sarbanes-Oxley also established independence requirements for the audit, compensation, and nominating/corporate governance committees, and it expanded the role of the audit committee.[140]

There were also changes related to the composition and attitude of shareholders. These included a continued increase in institutional shareholdings, the advent of hedge funds committed to influencing particular management decisions, a willingness on the part of traditional institutional shareholders to engage in activism, and the emergence of proxy advisory firms, most notably Institutional Shareholder Services, Inc. (ISS), to provide information to institutional shareholders regarding governance at particular firms and, in effect, to coordinate the investors' actions.[141]

According to Kahan and Rock, the result of these legal and institutional changes has been independent directors who are less likely to be "yes-men" to the CEO. Not only are directors less subject to domination by the CEO, they are the target of shareholder demands.[142] As Kahan and Rock explain, directors' conceptions of their role changed during this period—they became not just nominally independent but "substantively" independent.[143] This substantive independence is evident in surveys regarding how directors spend their time, how much time they devote to their board responsibilities, and how they view their roles.[144] It is also evident in their responsiveness to shareholders, as discussed below.

The most telling measure of the impact that these changes have had on governance is the rate at which directors have agreed to destagger their boards—after nearly two decades of refusing to do so. According to one study of the period from 2003 to 2010, approximately sixty firms per year destaggered their boards—compared to an average of four firms per year from 1987 to 2002.[145]

The dismantling of staggered boards has been directly related to shareholder activism; firms that destaggered their boards had been targets of shareholder proposals more frequently than those that did not destagger.[146] In addition, destaggering of boards occurred more quickly among firms targeted by hedge

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140. *See* Sarbanes-Oxley Act § 301, 116 Stat. at 775-77; NASDAQ STOCK MARKET RULES § 5605(c)-(e); NYSE LISTED COMPANY MANUAL § 303A.04-.07.

141. Kahan & Rock, *supra* note 134, at 995-1007.

142. *Id.* at 1025.

143. *See id.* at 1022.

144. *Id.* at 1022-32.

145. *See* Re-Jin Guo et al., *Undoing the Powerful Anti-Takeover Force of Staggered Boards*, 14 J. CORP. FIN. 274, 278 fig.1 (2008) [hereinafter Guo et al., *Undoing*]; Re-Jin Guo et al., Activism and the Shift to Annual Director Elections 30 fig.1 (Apr. 2, 2013) (unpublished manuscript) (on file with author) [hereinafter Guo et al., Activism].

146. *See* Guo et al., *Undoing*, *supra* note 145, at 282 ("The existence of prior shareholder proposals to de-stagger the board . . . is strongly related to the firms' decision to destagger.").

fund activists than among those targeted only by shareholder proposals.[147] Consistent with the studies of staggered boards described above, announcements of decisions to destagger boards yielded statistically significant, positive abnormal returns, with the largest returns occurring in firms subject to hedge fund activism.[148]

A new corporate governance measure that may increase management responsiveness to shareholder demands is majority voting, a shareholder voting regime that requires directors, when running unopposed, to receive a majority of votes to be assured of retaining their seats. From 2003 to 2009, the number of S&P 100 firms that had adopted majority voting rose from ten to ninety,[149] and from the beginning of 2006 through 2007, the percentage of S&P 500 firms that had adopted majority voting rose from 16% to 66%.[150] Although it is rare that a director loses his or her seat by failing to receive a majority of votes,[151] the advent of majority voting and "just vote no" campaigns threatens to shine an unfavorable spotlight on directors who take actions with which shareholders disagree. This is borne out by a recent study finding that majority voting increases firms' responsiveness to shareholder concerns.[152] That study also found that the adoption of majority voting was associated with an increase in share price.[153]

In sum, the balance of power between management and shareholders seems to have changed in the mid-2000s. This is best reflected in management's increased responsiveness to shareholders' longstanding demand that staggered boards be dismantled.

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Developments since the mid-2000s are surprising in two respects. First, management has responded to shareholder demands as never before. Second,

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147. Guo et al., Activism, *supra* note 145, at 17.

148. *Id.* at 19-21.

149. Kahan & Rock, *supra* note 134, at 1011 tbl.3.

150. CLAUDIA H. ALLEN, NEAL, GERBER & EISENBERG LLP, STUDY OF MAJORITY VOTING IN DIRECTOR ELECTIONS (2007), *available at* http://www.ngelaw.com/files/Uploads/Documents/majoritystudy111207.pdf.

151. Yonca Ertimur et al., Does The Director Election System Matter? Evidence from Majority Voting 29-31 (Jan. 4, 2013) (unpublished manuscript). A revised version of this paper is available at http://ssrn.com/abstract=1880974.

152. Firms with majority voting tend to implement successful shareholder proposals more often than firms with plurality voting. In addition, when shareholders withhold votes as a means of expressing dissatisfaction with a general governance matter, as opposed to dissatisfaction with a particular director, firms with majority voting are more likely to address the matter than are firms with plurality voting. *Id.* at 20-22, 25-27.

153. *Id.* at 15; *see also* Jay Cai et al., *A Paper Tiger? An Empirical Analysis of Majority Voting*, 21 J. CORP. FIN. 119, 129-30 (2013) (finding a positive price reaction to the announcement of a proposal to adopt majority voting).

an innovation occurred in shareholder voting, and it occurred at the midstream stage, not the IPO stage. While publicly held firms were adopting majority voting, essentially no companies going public were committing to majority voting.

Is the recent responsiveness of boards to shareholder demands what the contractarians expected? I do not think so. It took twenty years to occur, far longer than contractarian theory would predict. More importantly, there were identifiable institutional changes associated with management's responsiveness. There were changes in the law governing board independence; there were the Enron and WorldCom scandals highlighting the failure of the companies' outside directors to perform as expected; there was the rise of the governance-oriented proxy advisory business and especially ISS; and there was governance activism by hedge funds. This was not the invisible hand alone, but rather a change in institutions that appears to have reoriented the self-conception of independent directors. Casual observation suggests that the press has played a role as well in both promoting the self-conception of the independent director as actually independent, and threatening to damage the reputation of a director who fails to act in good faith pursuit of shareholder interests. Of course, institutions change as a result of market forces. The rise of governance-oriented hedge funds is a response to a perceived market opportunity, as is the rise of ISS. But especially in light of the legal reforms that have occurred, the governance experience since the mid-2000s is far from a validation of contractarian expectations for midstream governance.

As for innovation, institutional changes may explain that as well and may portend more midstream innovation in the future. The majority-vote campaign was highly visible, with ISS taking a position. The pros and cons of alternative approaches to majority voting were addressed in public fora. And firms adopted majority-voting regimes in high numbers very quickly. Any firm that adopted majority voting knew that it would not be alone, and that legal issues that arose would likely be shared, and ideally addressed, by another firm first. In other words, firms that adopted majority voting had the benefit of a network of firms that had done, or would soon do, the same. In the current environment, the visibility of governance issues and the ease of coordination may make the midstream stage better suited for innovation than the IPO stage, which at this point has relatively little visibility or coordination.

IV. A BRIEF DETOUR: ONGOING MISUNDERSTANDINGS REGARDING TAKEOVER DEFENSES AND GOVERNANCE INDICES

One theme of this Essay has been that the contractarian theory failed to take into account institutional facts—for example, the presence of staggered boards in IPO charters. The empirical literature has provided the facts needed to reassess the contractarian theory and more broadly to enhance our understanding of corporate governance. But as I indicated in Part III, the empirical literature on takeover defenses also exhibited a failure to accurately incorporate institutional facts. In this case, it was the precise ways in which takeover defenses work and relate to one another. In this Part, I use the recent explosion in the use of governance indices to briefly explain some of the misunderstandings in the current empirical literature. Again, my goal is to promote better models.

As Coates explained in an article published in 2000, the takeover studies of the 1980s and 1990s were often poorly designed, their results were misinterpreted, and a lot of econometric firepower was wasted.[154] Today, something similar is happening with governance indices.[155] Governance indices are intended to measure the degree to which management is vulnerable to being replaced by shareholder action. The elements of the indices are thus seen as potential causes of management entrenchment. This is where the problem lies. Many elements of the indices cannot *cause* entrenchment, and others that can cause entrenchment do so only under limited circumstances. As a result, the indices contain unnecessary noise, but more importantly, each noncausal element in the index introduces a hook for spurious correlation or correlation with no potential causation.

One commonly used index was developed by Paul Gompers, Joy Ishii, and Andrew Metrick (often referred to as GIM).[156] Known as the "G Index," it is comprised of twenty-eight elements intended to measure "the balance of power between shareholders and managers,"[157] by which the authors mean the ease

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154. Coates, *supra* note 100.

155. Bebchuk reports on his website that as of June 2013, at least 158 studies have used the E Index that he and his coauthors developed. Lucian Arye Bebchuk, *Links to 158 Studies Available on SSRN That Use the Entrenchment Index (Bebchuk, Cohen, and Ferrell, 2009)*, HARV. L. SCH., http://www.law.harvard.edu/faculty/bebchuk/studies.shtml (last updated June 2013); *see also* Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance*, 22 REV. FIN. STUD. 783 (2009) (developing the E index). The G Index, discussed below, was developed before the E Index and presumably has at least as many users.

156. Gompers et al., *supra* note 90.

157. *Id.* at 109. The G Index includes the following elements:

- Blank check preferred stock
- Staggered board
- Shareholders' inability to call a special meeting
- Prohibition on shareholder voting by written consent
- Change in control provision in executive compensation plan
- Golden parachutes
- Indemnification agreements with officers and directors
- Indemnification of officers and directors in bylaws
- Exculpation of outside directors for violations of the duty of care (e.g., under DEL. CODE ANN. tit. 8, § 102(b)(7))
- Executive severance agreements not contingent on change of control
- Restrictions, such as supermajority vote requirement, on bylaw amendments by shareholders
- Restrictions, such as supermajority vote requirement, on charter amendments by shareholders
- Absence of cumulative voting
- Absence of confidential voting by shareholders
- Supermajority shareholder vote required for mergers

with which shareholders can replace directors through either a hostile takeover or a proxy contest.[158] Gompers et al. assign a score to a firm based on how many of the twenty-eight elements it has adopted, or that apply under state law. They find that firms with scores in the lowest decile (the "Democracy Portfolio") were valued higher than, and outperformed, firms in the highest decile (the "Dictatorship Portfolio") from 1990 to 1999.[159] The G Index thus appears to be measuring something. The question is what. As I explain, it is implausible that the presence of a larger number of G Index elements *causes* management to be more entrenched.

At the most general level, there are two related weaknesses in the G Index. First, the Index gives equal weight to elements that have unequal impacts on entrenchment. This aspect of the Index reflects a reasonable judgment that a degree of inaccuracy is a cost worth bearing for the virtue of tractability. But given this judgment, the Index should not include elements that have a very low or highly contingent impact. A related and more serious weakness is that the G Index includes many such elements. Specifically, the Index includes elements that have (1) no impact on management entrenchment, (2) no impact on entrenchment if a firm has an effective staggered board, (3) an impact on entrenchment only under limited circumstances, or (4) no relevance to entrenchment and in fact affirmatively beneficial impacts on governance. Some of these problems stem from the fact that Gompers et al. built their Index using an existing dataset constructed by the Investor Responsibility Research Center, and were thus limited by what that dataset included. They also assumed that whatever was included in the dataset had the potential to entrench management. Whatever the explanation, however, the result is an index that has been widely used but that does not do what it has been understood to do. I provide examples below.

- Unequal voting based on duration of shareholding (not dual-class stock)
- Antigreenmail charter provision
- Nonshareholder constituency charter provision
- Fair price charter provision or applicable state statute
- Pension parachute
- Poison pill
- Silver parachute
- Antigreenmail statutory provision applies
- Business combination statute applies
- Nonshareholder constituency statute applies
- Cash-out statute applies
- Fair price statute applies
- Control share acquisition statute applies

Id. at 112, 145-50. Other commonly used indices are the E Index developed in Bebchuk et al., *supra* note 155, and an index developed in Lawrence D. Brown & Marcus L. Caylor, *Corporate Governance and Firm Valuation*, 25 J. ACCT. & PUB. POL'Y 409, 411 (2006).

158. *See id.* at 107-09.

159. *Id.* at 109-10.

A. *Elements with No Impact on Management Entrenchment*

One element of the G Index is a firm's adoption of a poison pill. As discussed in detail in Part III.A, the presence or absence of a pill at any particular time has no impact on a firm's ability to defend against a takeover bid when one arises. A company's board can adopt a pill unilaterally at any time, and it *will* adopt a pill in the face of a hostile takeover bid. Therefore, in effect, *every firm has a poison pill at all times*. Scoring a company based on the presence of a pill at any moment in time is therefore an invalid approach to measuring entrenchment.

In addition, the G Index includes the following takeover defenses, in the firm's charter or in the law of the state in which the firm is incorporated: (1) a business combination statute; (2) a fair price statute or charter provision; (3) a control share acquisition statute; and (4) a cash-out statute.

Since the advent of the poison pill, none of these defenses has an impact on a firm's exposure to a hostile takeover. Viewed in isolation, they would impose costs on an acquirer that carries out a hostile acquisition—meaning a tender offer that the target management opposes at the time it is carried out. But a pill imposes a prohibitive cost on an acquirer that goes forward with an acquisition while the pill is in place. Therefore a pill is a complete defense—no acquisition will occur while a pill is in place, and again all firms, in effect, have a pill. Consequently, at the margin these defenses have no impact.

The counting of takeover defenses in the G Index reflects a pervasive misunderstanding in the finance literature that has persisted since the 1980s: that, like cannons around a fortress, more takeover defenses means more entrenchment. As a legal and factual matter, this is incorrect. More defenses do not mean more entrenchment, and counting the number of defenses is not a valid way of measuring a firm's exposure to the market for corporate control or any other aspect of a firm's governance.

B. *Elements with No Impact on Firms with an Effective Staggered Board*

As explained in Part III.A, the most important takeover defense is an effective staggered board.[160] An effective staggered board allows a target to keep a poison pill in place for roughly two years, which has proven to be a serious impediment to a hostile takeover. There has never been a hostile acquisition of a firm with an effective staggered board where the firm kept its pill in place.[161]

160. *See* Bebchuk et al., *supra* note 101, at 910, 913 (defining an "effective" staggered board). Gompers et al. excluded dual-class stock from the G Index. I am therefore excluding it from this analysis as well.

161. *See* Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d. 48, 105 (Del. Ch. 2011) ("[N]o bidder to my knowledge has ever successfully stuck around for two years and waged two successful proxy contests to gain control of a classified board in order to remove a pill.").

Acquisitions that have occurred have ultimately been negotiated with management. Thus, for firms with staggered boards, other potential defenses included in the G Index (aside from a poison pill) are of no consequence at the margin. This is of course true of the four defenses discussed in Part IV.A, above, but it is true of others as well. Consequently, assigning points for these elements to firms with effective staggered boards misrepresents the impact of those defenses.

For example, the following two elements of the G Index are essentially irrelevant to a company with a staggered board as a matter of law: (1) the inability of shareholders to call a special meeting (due to a blanket prohibition or a high vote threshold for doing so), and (2) a prohibition on shareholders voting by written consent. These potential charter provisions come into play if a target board keeps its pill in place and "just says no" to a hostile bidder. In that scenario, as I have explained, the acquirer may seek to have target shareholders replace the target board with a board that will disable the pill and allow an acquisition to proceed. To do so, shareholders need an opportunity to elect directors. One opportunity is the target's next annual shareholders' meeting. But that could be a year off. A more timely way to hold a shareholder vote is for shareholders either to call a special meeting or to vote by written consent. This, however, is impermissible for firms with staggered boards. The law governing staggered boards requires that directors be elected at annual meetings only.[162] These elements of the G Index, therefore, are relevant only to firms with annually elected boards.

Additional elements of the G Index that do not have a causal impact on firms with effective staggered boards are the three supermajority vote requirements—to amend bylaws, to amend charters, and to approve a merger. Whether these requirements have an impact at the margin for firms with annually elected boards seems doubtful once they adopt a poison pill, but for firms with an effective staggered board, it is implausible.

C. *Elements with an Impact Only Under Limited Circumstances*

Some elements of the G Index can have an impact on management entrenchment, but only if other elements are also present. The clearest examples are two of the elements discussed above: a restriction on shareholders calling a

162. MODEL BUS. CORP. ACT § 8.06 (2007); DEL. CODE ANN. tit. 8, § 141(d) (2013). As discussed in the next Subpart, these provisions can be useful for a company with an *ineffective* staggered board, where shareholders might be able to replace the board immediately by passing a bylaw amendment. It is also possible that, for companies with an effective staggered board, one of these provisions could be used for a bylaw amendment that would facilitate an earlier takeover at the margin. This is what shareholders attempted (unsuccessfully) to do in *Airgas, Inc. v. Air Products & Chemicals, Inc.*, 8 A.3d 1182 (Del. 2010), but especially following *Airgas*, such use of these provisions will not have a substantial impact on entrenchment.

special meeting and a prohibition on shareholder voting by written consent. As just explained, these elements come into play if a target board keeps its pill in place and "just says no" to a hostile bidder. If shareholders do not have access to these means of electing a new board, an acquirer will be delayed until the target's next annual meeting, where an election of directors must occur.[163] In order to delay a shareholder election until the next annual meeting, however, *both* restrictions must be present. Either one alone is not sufficient. Consequently, assigning one point for either provision alone is not appropriate—nor is assigning two points for both.

D. *Elements That Are Unrelated to Entrenchment and Affirmatively Good for Corporate Governance*

The G Index also contains several elements that are not takeover defenses, that have no bearing on management entrenchment whatsoever, and that are widely understood to be beneficial from a governance standpoint. These include director indemnification provided for in bylaws, director indemnification provided by agreement, and protection of outside directors from monetary liability for violation of the duty of care. These provisions protect either management or the board from liability, primarily in suits brought by plaintiffs' lawyers on behalf of shareholders or the corporation. All of these protections have exceptions for actions that directors or officers have taken in bad faith.[164] They are thus not licenses to steal or to shirk. It is widely agreed that directors and officers generally should be protected from the expense of shareholder lawsuits, even if this protection occasionally extends to individuals who have engaged in misconduct. That activist shareholders generally do not oppose indemnification and protection from liability indicates that these protections are consistent with shareholder interests. Indeed, without such protection, it would be difficult to attract outside directors, and perhaps even top-level officers, to public companies, and those who are attracted would take few risks, regardless of the rewards to shareholders.

E. *Use of Governance Indices in Other Research*

Despite the shortcomings of their Index, Gompers et al. made a valuable contribution to our understanding to corporate governance. The primary problem with the G Index (and other governance indices) is that they have been widely used as all-weather, all-purpose measures of either takeover exposure, takeover likelihood, or governance quality generally. Moreover, among those

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163. The duration of the delay would depend on when the takeover bid begins in relation to the target's next annual meeting and the extent to which the state law governing the target allows it to delay its annual meeting.

164. *See* DEL. CODE ANN. tit. 8, § 145 (allowing companies to indemnify individuals who acted in good faith).

who have used the G Index and other indices, misunderstandings are rampant. Studies commonly refer incorrectly to *all* elements of the G Index as "takeover defenses," and they make the common mistake of assuming that the number of takeover defenses is a relevant measure of exposure to takeovers.[165]

One study of family-owned firms uses the G Index, which the authors describe as counting the "number of governance provisions in a firm's charter, bylaws, or SEC filings that reduce shareholder rights."[166] They further misdescribe the Index as an indicator of "minority shareholders' risk of expropriation."[167] In another study, Thomas Bates and his coauthors also misunderstand the G Index. Controlling for staggered boards, they find that the remaining elements of the G Index has a positive and statistically significant effect on the incidence of a takeover bid. They interpret this finding as indicating that, controlling for staggered boards, "firms with more anti-takeover provisions are more likely to receive a takeover bid."[168] This interpretation reflects a misunderstanding of the G Index elements and a misinterpretation of their results. It will likely lead to yet further misinterpretations as researchers try to discover why "anti-takeover provisions" attract takeover bids.[169] These misunderstandings are just a few examples of a widespread phenomenon.[170]

The G Index simplifies a set of complex relationships, which is necessary in order to make empirical analysis tractable. But the particular simplifications embedded in this Index (and others), coupled with the fact that researchers do not understand the underlying governance mechanisms, has resulted in widespread confusion in the empirical governance literature. In the law and economics field, there is a saying: "If a law professor wants to write a paper that is economically sophisticated, he or she needs an economist as a coauthor; if an economist wants to write a paper that is legally sophisticated, he or she needs to take a lawyer to lunch." My review of the literature based on governance indices using governance indices suggests that more lunches with lawyers are needed.

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165. *See, e.g.*, Bates et al., *supra* note 115; Johnson et al., *supra* note 29; Masulis et al., *supra* note 117.

166. Belen Villalonga & Raphael Amit, *How Do Family Ownership, Control and Management Affect Firm Value?*, 80 J. FIN. ECON. 385, 390, 396 (2006).

167. *Id.* at 396.

168. Bates et al., *supra* note 115, at 671.

169. As explained above, several of the G Index elements are unrelated to takeovers, and others that relate to takeovers would be expected to have no appreciable effect on receiving a bid. Yet others, including golden parachutes as Bates et al. found, would be expected to increase the likelihood of a bid. *Id.* Other elements not discussed here that may increase the likelihood of a bid are: change in control provisions, pension parachute, and silver parachute.

170. Economist friends of mine have explained that it has become routine for referees to ask authors to add a governance index to their models. The referee process may thus be a conduit of confusion in this area.

INTERPRETATION, IMPLICATIONS, AND CONCLUSION

The primary question this Essay has addressed is whether the empirical evidence that has accumulated over the past two decades supports the contractarian theory. The answer to that question is no. The IPO charter is not the fount of innovation and customization that the contractarian theory implied it would be. It is instead a plain vanilla document that commits management to default rules, and often to a staggered board as well.

Nor is there a race among states—to the top or bottom. Delaware faces no competition. Firms may incorporate in their home states, but those decisions do not appear reflect a judgment that their home state's law is better than Delaware law. Nonetheless there is an empirical basis for concluding that Delaware produces value-enhancing corporate law.

In this Essay and in prior work, I have offered a theory based on network economics to explain why default rules are more attractive than customized charter terms, and why Delaware will remain the dominant state of incorporation even if other states attempt to compete.[171] Default rules and Delaware incorporation offer network benefits that customized contracts and incorporation in states other than Delaware cannot provide. Network externalities were not understood at the time the contractarian theory was developed, and in my view their presence in corporate law and contracting explains why the contractarian theory is not valid as a positive theory—and therefore not valid as a normative theory either.

There are at least two implications of the network externality theory as a positive explanation of corporate law and governance. First, corporate governance arrangements that exist are not necessarily socially optimal, as the contractarian theory posited. Second, corporate law's impact is much greater than the theory implied. Firms will adopt socially suboptimal default rules, and they will decline to adopt socially optimal governance arrangements if they are uncertain about whether other firms will adopt them as well. Such suboptimal equilibria are the result of a collective action problem. Firms have difficulty coordinating to form networks around innovative governance arrangements. Consequently, as a normative matter, there is room to argue for changes in corporate default rules or for corporate law to offer menus of standardized governance choices. Contractarians cannot reasonably argue, as they frequently have,

171. Klausner, *supra* note 19. Others had made closely related observations. Romano, for example, described Delaware's lead in terms of a first-mover advantage with respect to its stock of precedents. Romano, *supra* note 54, at 226, 240. Ayres argued that corporate law's default rules should take the form of general standards, rather than specific rules, because general standards offer the benefit of ex post application by courts on a case-by-case basis. Ayres, *supra* note 19, at 1403-13. In addition, Henry Hansmann later added the observation that default rules are updated by statutory amendments. Consequently, by adopting a default rule, a firm reaps not only the network benefits of future judicial interpretations, but statutory updates as well. Hansmann, *supra* note 19, at 9-10.

that if a governance arrangement is not present in IPO charters then there is no basis for a court, legislature, or the SEC to adopt it. The network externality theory does not, however, imply a role for mandatory corporate law. To the contrary, it implies that care should be taken in writing default rules because they can result in suboptimal adoption without being mandatory.

Network externalities do not explain the adoption of staggered boards at the IPO stage. This phenomenon remains a mystery. Johnson et al. appear to provide a partial answer based on commitments to long-term business relationships, but there remain many staggered boards that are unexplained. Doubts have been raised regarding whether pre-IPO shareholders bear a cost when they take companies public with staggered boards. The contractarian expectation that they do seems sound as a matter of theory, but those doubts should be taken seriously and investigated further.

A surprising development in recent years is the innovation of majority voting and its rapid and widespread adoption. This innovation arose among firms that were already public, and may portend future innovation at the midstream stage. With the advent of activist hedge funds and high-visibility debates over governance arrangements, firms may be able to coordinate the design and adoption of de facto governance standards. Furthermore, majority voting itself may reduce the resistance of management to shareholder demands. The midstream stage may thus prove to be better suited than the IPO stage as a locus of innovation—at least until similar institutions develop that focus on IPO charters and facilitate coordination.

Finally, a secondary theme of this Essay has been the failure of both theorists and empiricists to pay sufficient attention to institutional facts. For contractarian theorists, the presence of staggered boards and the absence of innovation or customization in IPO charters were there to be seen. But no one looked. For empiricists, the mechanics of takeover defenses can be learned. But many modelers of corporate governance have not yet put in the effort. Consequently, defenses are incorporated into models—and into governance indices, which in turn are incorporated into models—in ways that are incorrect. When this occurs the results of the models cannot be trusted.