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Thinking to be Paid versus Being Paid to Think

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In the first chapter of *The Economic Structure of Corporate Law*, Frank Easterbrook and Daniel Fischel make an arresting statement:

> . . . [P]eople who are backing their beliefs with cash are correct; they have every reason to avoid mistakes, while critics (be they academics or regulators) are rewarded for novel rather than accurate beliefs. Market professionals who estimate these things wrongly suffer directly; academics and regulators who estimate wrongly do not pay a similar penalty. Persons who wager with their own money *may* be wrong, but they are less likely to be wrong than are academics and regulators, who are wagering with other peoples' money.[1]

In other words, society should trust decisions to people who put their money where their mouths are.

When I first read this passage, I was a bit perturbed. Now that Easterbrook and Fischel had published the book that pulled together their many important contributions to corporate law, it looked like they wanted to put the rest of academia—and *The Journal of Corporation Law*—out of business. More dispassionate reflection, however, reveals that there is something to what they have to say.

To start, Easterbrook and Fischel certainly raise a critical issue: what is the proper allocation of responsibility for making economic decisions in a world where the future is uncertain and knowledge is dispersed unevenly? In essence, they are asking how much deference should be given to the views of those who back up their views with cash—the persons who think to be paid—and how much to regulators and academics—those who are paid to think. Regulators have well-catalogued vices. Academics—the source of many regulator ideas—have their faults as well. During Robert Bork's ill-starred Supreme Court confirmation hearings, Senator Orin Hatch, asserting that Bork did not fully believe some of the more unpopular things that he put in his academic writings, argued that Bork, as a professor, "was paid to be provocative."[2] The anger that this alliterative phrase aroused among academics suggests that it hit the raw nerve of ambivalence between their roles as direct seekers of truth and as stimulators of

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1. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 31 (1991).

2. Linda Greenhouse, *Stakes of the Bork Fight; With Senate Hearings Starting Tomorrow, Both Sides Have Much to Gain or Lose*, N.Y. TIMES, Sept. 14, 1987, at A1.

intellect. Moreover, while it may be more a product of temperament and impecuniosity, academics do seem shy about testing out their theories with their own money. It is significant that John Kenneth Galbraith, a man famous for believing in the frequent foolishness of businessmen and the wisdom of at least one academic, chose fiction as his way of exploring the possibility of such a test.[3] The protagonist in his recent novel, *A Tenured Professor*, is a professor who makes a fortune testing his contrarian predictive model of the economy by using it as a guide to investing in the stock market.[4] No evidence exists that Galbraith has taken his fantasy to heart yet and tried to do the same in his own life.

Nevertheless, Easterbrook and Fischel's quoted passage requires more critical examination. Their breezy style, while promoting clarity and impact, masks a number of assumptions, and we need to exercise care in where we apply their advice. The specific context in which Easterbrook and Fischel make their statement is as part of an argument that legislatures and courts should give great deference to the language of articles of incorporation.[5] An extensive amount of literature suggests that the application of their statement even to this issue needs substantial qualification.[6] But the statement is more broad reaching than that and represents a core element in their overall promarket, antiregulatory philosophy. The statement obviously invites rigorous theoretical analysis. In this discussion, however, I am going to examine its limitations in a more concrete way by relating it to three events that have been in the financial news over the last year; (1) the allegations against Prudential Securities in connection with the sale of limited partnerships to the public in the 1980s; (2) the conversion of mutual savings and loans into banking corporations; and (3) the short sales by market makers of the stocks of bankrupt firms at prices well above what any informed observer possibly could consider they were worth.

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3. *See generally* JOHN A. GALBRAITH, A TENURED PROFESSOR (1990).

4. *Id.*

5. EASTERBROOK & FISCHEL, *supra* note 1, at 31.

6. The argument, originally offered by Jensen and Meckling, is that a corporation's articles of incorporation will represent the best available set of constraints for minimizing the agency costs of management. The argument is based on the idea that when a firm's entrepreneurs initially offer shares to others, their sale price accurately reflects the expected agency costs implied in the terms chosen. The wealth of these entrepreneurs, who at the time of offering own the whole firm, will thus be diminished dollar for dollar by the reduction in share value resulting from any nonshare value maximizing behavior expected under these terms. Since the entrepreneurs' gain in utility from such behavior is never as great as their loss in utility from the wealth loss, they have an incentive to choose the terms that keep agency costs at their minimum. Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 312-19 (1976). The Columbia Law Review devotes the entire November 1989 issue to articles debating this proposition. I have questioned elsewhere whether the market actually takes note of such terms and accurately reflects their implications, and even if it does, whether, in the case of articles of the corporations that dominate the industrial sector (most of which issued the bulk of their stock between 50 and 100 years ago), their initial articles would be, or as amended are, agency cost minimizing today. *See* Merritt B. Fox, *The Role of the Market Model in Corporate Law Analysis: A Comment on Weiss and White*, 76 CAL. L. REV. 1015, 1041-42 (1988); MERRITT B. FOX, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY: THEORY, PRACTICE AND POLICY 140-143 (1987) [hereinafter, FOX, FINANCE AND INDUSTRIAL PERFORMANCE].

I. THREE CASE STUDIES

A. Prudential Securities Limited Partnerships

During the 1980s, Prudential Securities sold about eight billion dollars worth of limited partnership interests to the public through their brokers.[7] Many of these securities subsequently lost much or all of their value. Prudential agreed with the Securities and Exchange Commission (SEC) to pay an initial "down payment" of $330 million into a settlement fund. Some, perhaps optimistic, plaintiffs' lawyers predict that Prudential ultimately will have to pay as much as three billion dollars into this fund.[8] The crux of the complaint against Prudential is that for a large number of the purchasers, these investments were unsuitable.[9]

The story has a couple of interesting aspects. First, the whole idea of regulating the relationship between brokers and customers with rules about suitability is the very antithesis of respecting the decisions of people who put their money where their mouths are. Does that mean that the suitability doctrine should be eliminated? I suspect not, at least not in a case like this. Based on reports in the financial press, it appears that billions of dollars of securities came into the hands of people who, even viewed from the *ex ante* perspective of the time of purchase, would have been better off if they had not bought the securities. Based upon the best knowledge available at the time of purchase, these securities had questionable expected rates of return. And, in any event, there was a mismatch between the purchasers' low risk preferences and the securities' high risk characteristics. These did not just turn out to be bad deals in the end; for these purchasers, they were bad deals from the beginning.

The other point of interest relates to the role of reputation in the models that find unregulated markets make superior decisions even in a world with unequal distribution of information. Somehow Prudential allowed the use of its rock solid trade name in a massive way that gave customers confidence in brokers who, in pursuit of high up-front commissions, were pushing purchases of securities quite contrary to the customers' interests. As a result, "Prudential", as a name for a securities company, has been sufficiently sullied to become a bit of an oxymoron.

Persons who worship market solutions tend to assume that reputation sullying of this kind will rarely, if ever, occur. These worshippers believe companies are rational maximizers of share value. Except in end game situations, it is irrational for a company to let such sullying occur. Here, though, we have an example of just that kind of irrationality on a massive scale. Surely Prudential's loss in reputational capital in the 1990s greatly exceeds its additional profits from pushing these securities in the 1980s.[10] Proponents of the market superiority models underestimate the degree to which

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7. *See* Scot J. Paltrow, *Prudential to Pay at least $371 Million in Fraud Settlement*, L.A. TIMES, Oct. 22, 1993, at D1.

8. *Id.*

9. *Id. See also* Sharon Walsh, *At Prudential, the Fraud Case that Won't Die: Investigations of Partnership Sales Continue Despite Huge Settlements*, WASH. POST, Feb. 13, 1994, at H1.

10. For a discussion of the potentially devastating effect of this matter on the financial well-being of Prudential Securities, see Sharon Walsh, *supra* note 9.

intraorganizational dynamics lead to this kind of irrationality and consequent social damage. Some businesses, such as financial firms and law firms, are based particularly on trust and cannot operate successfully on a large scale without substantial reputational capital. One of the most difficult things for a business of this sort to do is to set up a system that creates incentives for its individual members to add to the organization's profits and to act in a way that preserves its reputation. The potential for failure in industries of this kind creates a strong case for regulation.

B. Mutual Savings and Loan Conversions

Now consider the conversions of mutual savings and loans into banking corporations that have been sweeping the country for the last two or three years. The mutual form of doing business—where the institution is "owned" by its depositors—appears to be outmoded. Without shares, the organization lacks both the carrots and the sticks necessary to attain good managerial performance: incentive plans are hard to design, and ousting management for lax performance is virtually impossible. It is also hard for mutuals to raise new capital or arrange mergers—serious problems in an era when banking is showing sharply increasing economies of scale. By eliminating these problems through the creation of institutions with stock, conversions can lead to significant increases in value. The typical transaction involves an initial offering of shares at a deep discount. The average increase in price in the first few weeks after the offering is somewhere between thirty-three and fifty percent.[11] The opportunity and ability to participate in an initial offering can, therefore, produce riches.

The charters of these mutuals and the statutes under which they operate appear to give management enormous discretion in determining who participates in the offering, and, at least until recently, regulators have taken a relatively hands off approach. As a result, management structured some deals so that only members of management and employees participate, thereby resembling the most criticized Eastern European privitizations. Others are designed to permit depositors to participate. In many of these cases, however, a large portion of the shares go to "professional" depositors. "Professional" depositors are persons who, sensing the trend, travel around the country placing small deposits in every mutual they can find. When the deals are announced, these city slicker depositors have the knowledge and resources to grab a big hunk of the shares. How the gains from these conversions should most appropriately be split up among managers, long-term local depositors, and recent out-of-town city slicker depositors is not immediately obvious. I am confident, however, that solid academic analysis using the best theoretical tools available could significantly illuminate this question.

Surely, the long-term local depositors were not consciously affirming an arrangement which permitted conversion gains to benefit others when they put their money where their mouths were. Nor has such an arrangement really proven to be the best structure by any other market test. The impression of unfairness is great, particularly in deals where all or a substantial portion of the discount shares are given to the managers. The managers' laxness under the mutual arrangement, after all, created much of the opportunity for gain from the conversion. The public views these deals as leftovers

11. Michael Quint, *Mutual Banks Moving to Shareholder Owners*, N.Y. TIMES, June 1, 1993, at D1.

from the greed decade of the 1980s, and the economy is not well-served by this perception. A more thoughtful approach to regulation would either give local, long-time depositors more of the gains, or provide a convincing, understandable rationale as to why failing to develop such a plan is not unfair.

C. Short Sales of Bankrupt Firm Equities

Finally, consider the trading of the shares of bankrupt companies such as LTV after court confirmation of reorganization plans that provided the old equity holders with nothing but a very small tidbit. In the LTV case, a market maker in the stock sold it short in an amount so large that the short sales exceeded the total number of outstanding shares.[12] Despite this massive short selling, the price stayed several times higher than what any well-informed investor would pay. There were clearly a lot of willing buyers—persons who put their money where their mouths were—who thought a possibility of a turnaround at LTV still existed. Obviously, they were either unaware of the confirmation of the bankruptcy plan or could not understand its significance. In this situation, where the short selling market maker was sure to win and the buyers sure to lose, the Exchange, while grumbling and wringing its hands, refused to act. It let trading continue.

Again, a minimally diligent regulator would know enough to see that stopping trading would be a superior result for the buyers, even if that meant overruling the judgment of those who were backing their beliefs with cash. The president of the market maker, when asked why he thought there was such a hue and cry about his practices, answered "jealousy" and suggested that it was not too late for others to become members of the Chicago exchange so that they could follow his example, after judicial confirmation of the next major bankrupt company's reorganization plan.[13] Events like these erode confidence in the market bit by bit, as an increasing number of people, either through direct experience or observing others, conclude that the market is nothing more than a place where sharp traders separate the perpetually hopeful from their money.

II. GENERALIZATIONS

These events suggest that situations exist where academics and regulators have a comparative advantage over people willing to put their money where their mouths are. The advice of academics is valuable especially in situations where private arrangements were set up at a time when no one contemplated the current state of affairs. The conversion of mutual savings and loan is an excellent example. Additionally, academics, as the people paid to be provocative, are society's bulwark against its common tendency to

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12. *See* Kurt Eichenhold, *Stock Strategy Under Scrutiny*, N.Y. TIMES, Aug. 26, 1993, at D1 (discussing the short sale of worthless shares of stock in LTV corporation); Thomas Gerdel, *New LTV Stock Drawing Investor Interest*, CLEV. PLAIN DEALER, June 19, 1993, at D2 (providing background about trading prices and value of LTV shares); Tom Petruno, *Market Beat: Market Watch; Gambling on the Bankrupt Bound*, L.A. TIMES, Feb. 11, 1991, at D5 (noting the general tendency of bankrupt firms to have overpriced shares as a result of the enthusiasm of amateur traders).

13. Eichenhold, *supra* note 12.

engage in "group think." Group think afflicts markets just as it does any other social institution. Many situations exist where people figure out that a particular group thought is wrong and are not able to trade profitably on that discovery or, even if they can, are not able to fully correct the market price through their actions. Prices are set by speculators. Successful speculation is the result of outguessing the competition on what the market will think next. The best guide to that may or may not be economic fundamentals.[14] Obviously, economic fundamentals were not the best guide in the case of LTV and Continental stock.[15]

Regulators have a comparative advantage over market participants with decisions involving the following, not uncommon, collective action problems: (1) for many individual private transactors, more work than they find worthwhile is required to be sufficiently informed to have a reasonably accurate view of the future, (2) there is reason to think that this work either will not be done privately by anyone or, if it is, that the results will not be fully and rapidly incorporated into market price (full and rapid incorporation protects the uninformed and informed alike), and (3) everyone's preferences and circumstances are sufficiently similar that, if in fact they all were informed, most people would decide the same way. The continued trading of the LTV shares is again a good example. It took work to figure out the true value of these shares, work that many investors did not find worthwhile to undertake. The true value was not reflected in price; and no one would have wanted these shares at anything approaching the price paid if they had done the work to figure out their true value.

III. Relevance to Corporate Lawyers in Their Own Lives

The ideas discussed here have, by way of analogy, significance to the editors and staff of this *Journal* as they go out to become the next generation of corporate lawyers.

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14. Speculators (i.e., persons who buy and sell on the basis of their best guess concerning future returns) are the persons whose actions have the potential of making the market relatively efficient with respect to information known by persons outside the firm. For a classic legal literature treatment of this phenomenon, see Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). However, even if the market is relatively efficient with respect to publicly available information in the sense that the ordinary investor cannot make money by trading on such information, the market may only be "speculatively efficient" (i.e., prices are, conditional on such information, unbiased predictors of future financial returns) and not "allocatively efficient" (i.e., prices are not unbiased predictors of the discounted value of the future cash flows produced by the issuers' underlying real assets, the subject of "fundamental" information). Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761 (1985). Some commentators dispute whether the market is efficient at all. They point to the existence of a large body of investors ("noise traders") influenced by "beliefs and sentiments . . . not fully justified by fundamental news" and to limitations on the ability of better informed, more rational investors to arbitrage away their influence on price. Andrei Shleifer & Lawrence Summers, *The Noise Trader Approach to Finance*, 4 J. ECON. PERSP. 19 (1990) (providing a nontechnical overview of the "noise" theory approach). *See also*, FOX, FINANCE AND INDUSTRIAL PERFORMANCE, note 6, at 36-59, 81-83.

15. The reader might sensibly ask why there were not so many short sellers that the price was forced down to the value of the tidbit. The answer appears to be that legal and ethical concerns apparently constrained others from acting. Eichenhold, *supra* note 12. It might be argued that these concerns are the real source of the problem and that their elimination is a better solution than the regulatory response of suspending trading. The story, however, suggests that there is a sufficient reservoir of poorly informed optimists that a large number of investors would suffer in the process of such a price adjustment.

Easterbrook and Fischel's statement represents an overly cynical view of the personal and social value of professionalism. You, too, will be paid to think. You, too, will be doing something positive by being provocative. You have been trained with analytical skills and a certain questioning kind of skepticism that can be the bulwark against your client's tendency to engage in group think. Just because something is done some particular way by everybody doing deals, do not hold back from taking a fresh look and do not be afraid to ask questions. The assumption that all the people who are putting their money where their mouths are necessarily know what they are doing can be grossly misleading. You are far more valuable to your client if you play the more proactive role suggested here, instead of just sitting back and being a mere scrivener. You will help your client both to seize opportunities missed by others and to avoid previously unseen pitfalls. And you will have a lot more fun.