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THE SHAPING FORCE OF CORPORATE LAW IN THE NEW ECONOMIC ORDER

Jeffrey N. Gordon*

I am very grateful for the opportunity afforded by this Allen Chair lecture. I grew up in Richmond. During my formative years, between zero and two, my family lived in an apartment on Grace Street, and my mother would push me in the stroller around the block of Lombardy and Grace, where the T.C. Williams Law School was once located. Given all we know about psychology, it surely must be the case that the subliminal suggestion of legal studies at that crucial time accounts for my present occupation as a law professor.

My topic for this Allen Chair lecture is the shaping force of corporate governance in the new economic order. It is easy to think of corporate law as an arcane field with mysterious terms and peculiar rules, ultimately of interest only to those who are prepared to bill at least 2000 hours a year to unravel its complexities. This is the view that there is a pointless mystery about shareholders, directors, common stocks, debentures, and

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the bizarre creature my class encountered recently, a convertible exchangeable cumulative preferred stock; and that ultimately corporate law and practice consists of the expert manipulation of formal rules and practices, which is of importance to the particular parties in a particular matter, but of little global importance.

I want to articulate a different position: that corporate law, and the associated corporate governance regime, is a very important variable in determining economic performance. I want to explore this thesis in terms of the shaping influence of corporate law, in what I call the New Economic Order. I then want to take up Virginia corporate law, which, as reflected in the outcome of the control contest for the Shenandoah Valley poultry producer, WLR, takes a decidedly negative stance on the market in corporate control. Anti-takeover animus has produced anti-takeover laws in Virginia that seriously distort longstanding corporate law norms governing the conduct of directors and that sweep far beyond any defensible objective.

I. CORPORATE GOVERNANCE AND CORPORATE LAW

By “corporate governance,” I mean the mechanisms by which various marketplace signals, particularly from product markets and capital markets, directly influence the makeup of the management team that makes economic decisions for the firm, and in that way, indirectly influence the economic decisions themselves. This is a somewhat broader, more abstract conception than “corporate governance” regarded as simply the arrangements between and among shareholders, the board, and the management team. “Corporate law” is a critical, but by no means necessarily determinative, element in a corporate governance regime.

Indeed, corporate governance may be thought of as a function of five distinct elements: a state's statutory regime; a state's common law of "fiduciary duties," which constrains actions that would be technically permissible under the statutes; the federal

2. See infra notes 32-34 and accompanying text.
securities system of mandatory disclosure of firm-specific information and the regulation of the proxy voting by shareholders; the corporation’s internal governance procedures; and the structure of share ownership of the particular firm and of firms generally. “Internal governance,” itself, is a broad category that includes several sorts of structural decisions undertaken by particular firms operating within the general framework of an enabling corporate law regime. These include: (1) structural decisions in the charter (and thus requiring shareholder approval for change) setting forth, for example, the size of the board and whether it is subject to annual turnover or “classified”; (2) structural decisions about the board undertaken by the board itself, such as the allocation of board seats between insiders and outsiders; and (3) structural decisions made by the board about the ability of the shareholders to accept an unsolicited tender offer for their stock, as through a “poison pill.”

The structure of share ownership is an important independent factor in determining the governance implications of a given state corporate law regime. In the classic story of the public corporation told by my Columbia predecessors, Adolph Berle and Gardiner Means, in the 1930s, the dispersal of share ownership necessitated by the corporation’s need to raise equity capital from diverse sources produced the separation of ownership from control.³ My current colleague, Mark Roe, has argued that this dispersed ownership pattern was also significantly influenced by a host of legal barriers to the holding of concentrated blocks of stock by financial intermediaries, these barriers arising at least in part because of populist concerns about faceless aggregations of wealth and power.⁴ Whatever the cause, the result is fragmented ownership of the public corporation and governance implications that follow. Dispersed shareholders will find it difficult and expensive to coordinate their actions, as through contested board elections, to replace management even under a corporate law regime (and internal governance rules) that make it relatively easy.

³. See generally Adolph A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property (1933).
The rise of institutional investor activism, beginning in the late 1980s, shows the governance implications of share ownership. Under the same legal regimes that produced decades of shareholder quiescence, firms now began facing insistent calls for restructuring internal governance procedures, including increasing the percentage of board outsiders and establishing codes of conduct for exercise of the board's oversight functions. Indeed, institutions have mounted successful campaigns against chief executive officers believed to be underperforming and have changed the nature of hostile takeover bids.

Hostile bids ultimately depend, however, on the strictly legal mechanisms of corporate governance, the corporate law. In getting a majority of the stock, the acquirer obtains the power to elect the board and, thus, control the firm's business decisions. Beginning in the mid-1980s, boards began adopting so-called shareholder rights plans, or "poison pills," which impose a severe financial penalty on an acquirer who obtains a controlling percentage without management approval. Potential acquirers came to realize that they could mobilize activist institutions to use their voting power to replace resistant boards, and began to couple hostile bids with consent solicitations or proxy contests. The point is that the same legal regime oper-

5. The rise of institutional shareholder activism is a story with two distinct elements, an increase in equity ownership and then an increase in activism. In 1950, institutional investors—banks, mutual funds, life insurance companies, and pension funds—held only approximately six percent of the U.S. equity market; by the mid-1980s, they held nearly fifty percent, an ownership percentage which has increased at a slower rate since. See 2 THE BRANCATO REPORT, PATTERNS OF INSTITUTIONAL INVESTMENT AND CONTROL IN THE USA 42 (1995) (hereinafter BRANCATO REPORT). This ownership change was fueled by the adoption in 1974 of the Employee Retirement and Income Security Act (ERISA), which requires funding of the pension promises of deferred benefit plans, and the growing belief on the part of individual investors that investing through financial intermediaries could enhance diversification and reduce the transaction costs of investing. See 29 U.S.C. § 1001 (1994)

The increase in institutional shareholder activism—and, here, one must be careful not to overstate the extent of it—arose out of the stresses of the takeover movement in the 1980s (and management's increasingly successful efforts to enlist legislatures and courts in anti-takeover measures). Many institutions, particularly public pension funds pursuing an indexing diversification strategy, came to realize that their inability to exit freely from an underperforming stock provided a reason to try to exert change through governance mechanisms.

6. For further thoughts about the board's power over the firm's receptiveness to hostile bids, see Jeffrey N. Gordon, "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffet, 19 CARDOZO L. REV.
ates very differently as a matter of corporate governance depending on whether a particular firm's shares are held by dispersed or concentrated owners, and more broadly, the general shareholding pattern across firms. That is, it is not only that governance operates differently in particular firms depending on the ownership structure of that firm, but that general ownership patterns may have systemic effects through the creation of new marketplace institutions and by the conditioning of expectations of the various governance actors, including boards and managers. For example, widespread institutional ownership has led to the various information gathering and advice-rendering activities of the Council of Institutional Investors. Similarly, boards and managements now seem much more receptive to engagement with large institutional owners than at the outset of institutional activism in the 1980s.

In cataloguing the sources of a corporate governance regime, it is also possible to include the role played by creditors, whose oversight operates less through corporate law than through the custom-tailored vehicle of a loan agreement or a bond indenture. For example, creditor monitoring operates directly through the financial requirement of loan repayment and also through the signaling entailed in discretionary decisions such as whether or not to roll over a current obligation or extend a credit line. Creditor monitoring plays a more significant corporate governance role in countries with a tradition of bank-centered financing, such as Japan or Germany. The monitoring role is enhanced by significant bank ownership, either direct or indirect, of corporate equity and, in some cases, exercise of proxy power over customers' shares on deposit.

Finally, it is also possible to imagine a corporate governance regime that explicitly sought to include influences beyond external marketplace signals. Arguably, the German system of codetermination, in which employee representatives sit on the "supervisory board" in a two-board structure, extends the objectives of the corporate governance regime beyond shareholder

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interests. Similarly, in the United States, some have argued that the interests of various stakeholders or constituencies other than shareholders, should be addressed in managerial decision making and have proposed governance schemes to implement this. But as demonstrated by the adoption of “constituency statutes” that permit, rather than mandate, a board to consider non-shareholder interests, no consensus in the United States has developed in favor of alternative governance objectives.

In thinking in a general way about corporate governance, particularly on a comparative dimension, it is also important to bear in mind the distinction between the “substitutability” and “complementarity” of various governance institutions. For example, some have argued that an appropriately energetic board is a “substitute” for the market in corporate control, meaning that both institutions ensure managerial accountability to shareholder interests. It is also possible to see the institutions as complements, meaning that the control market enhances the board’s role as a monitor by buttressing the board’s resolve to insist on managerial performance. Others have argued that large blockholdings can be a complement to a system in which employees play a significant governance role because only a large blockholder would have the resources to resist a tilt against shareholder interests in such a setting.

II. THE NEW ECONOMIC ORDER

The New Economic Order is the regime of economic liberalization ascendant in the United States for at least the past fifteen years. It has changed the competitive environment so as to place a premium on the firm’s capacity to adapt quickly to changing competitive conditions. Important features include relatively open and flexible markets in goods, capital and labor, both domestically and internationally. The economic consequenc-

NEW ECONOMIC ORDER have been dramatic, particularly in the sharp distinctions between winners and losers. Shareholders as a group have been enormous winners. The overall level of corporate profits has significantly increased throughout the period, by a total of nearly 300% in real terms, as have average stock prices. Although particular firms have failed in the competitive struggle, open capital markets have provided shareholders with ample diversification opportunities while the overall trend is powerfully up.

The story for employees is much more complex. In a nutshell, median wages are flat and wage inequality among income groups has grown; on the other hand, declining unemployment has increased the number of wage earners and provided wages to those who, otherwise, would have had no job. On balance, the aggregate income effects have to be counted on the negative side of the employee ledger. Real median wages have not grown very much during the period, perhaps five percent total, obviously much less than the growth in corporate profits or stock prices. This effect persists when various corrections are taken for demographic factors, such as changing family size and the entry of women into the work force, and also persists for various measures of employee compensation. An even more serious concern arises from the changing shape of the distribution. Real wages are declining in the bottom quintile and increasing at the top, and the number in the middle is a diminishing group. Thus, while a select group of employees are reaping significant gains, those gains are concentrated at the very top of the wage distribution, the top five percent and especially the top one percent.

The ambiguous impact of the New Economic Order on employee welfare also results from an arguable increase in job instability (the actual facts are in dispute). Highly publicized layoffs by firms such as AT&T at times of record profits (not just at a low point in the business cycle) have left many employees feeling insecure. Looked at in the aggregate, the general rate of employee displacement is not higher than earlier comparable periods. Nevertheless, recent displacements have been highly salient, in part, because the targets have increas-

11. See Gordon, supra note 1, at 1534-38.
12. See id. at 1538.
ingly included white collar employees and have hit those in mid or end-career positions, where the economic consequences have been very significant for the affected individuals. Moreover, most employees, unlike shareholders, cannot adequately diversify their firm specific risks. The diversification opportunities available in labor markets—for example, the acquiring of general, not firm specific skills, or retraining—are not nearly as effective as simple portfolio diversification, and employees typically do not have enough wealth to hedge the financial asset represented by their salary stream.

Against these employee effects must be weighed the dramatic increase in employment levels and the reduction of unemployment—a great boon to those who would fall off the wage distribution if unemployed. The U.S. economy has been creating jobs at a rate that is the envy of the developed world. While Western Europe suffers from unemployment rates edging beyond twelve percent, U.S. unemployment has fallen below five percent for the first time in a generation. These comparisons probably understate the real disparity in unemployment levels because rising unemployment discourages people from seeking work and, thus, lowers the reported statistic while declining unemployment works conversely. Greater employment opportunities not only enhance incomes, particularly of those at the bottom, but produce far-reaching social welfare benefits as well.

The New Economic Order, in significant measure, is due to the product of three interlinked legal regimes—trade, labor, and corporate governance. The importance of the trade regime and the labor regime to the New Economic Order has been widely recognized. The third element, the corporate governance regime, has an impact which I think has not been sufficiently appreciated. In particular, one of the most important choices made in a governance regime is the extent to which the management team is exposed to capital market pressures because the signals conveyed by capital markets would lead to quicker

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13. This is not to deny the significance of various elements of domestic macroeconomic policy, including the management of interest rates and monetary supply by the Federal Reserve and the fiscal policies at the federal level that particularly affect aggregate demand or the savings rate.
responses to changing competitive conditions. This adaptability may be a key element of success in the global marketplace.

III. TRADE

The liberalized trade regime arises principally from the post-World War II set of multilateral agreements that have reduced tariff and non-tariff barriers to the movement of goods across international borders. The importance of a liberalized trade regime to the New Economic Order comes principally from intensified product market pressures and new product market opportunities. Firms face competitive threats from all over the world and in turn have the opportunity to pursue competitive advantage on a worldwide scale. The competitive threats can take different forms, such as product innovation (e.g., the Sony Walkman), organizational innovation (e.g., the Japanese production methods that cut costs and raised quality standards for cars), or negative comparative advantage in the supply of a key input (e.g., lower labor costs that give East Asia textiles a price advantage).

The fall and rise of the U.S. automobile industry over the periods of the 1970s through the 1990s is instructive. In the wake of the 1973 oil embargo, fuel-efficient Japanese cars made significant inroads into the U.S. automobile market. U.S. consumers found they liked not only the fuel efficiency, but also the quality and reliability of the Japanese imports. Sales by domestic producers contracted; if not for a government loan guarantee program in the late 1970s, Chrysler Corporation would have been forced into bankruptcy. A “voluntary” import quota obtained by the U.S. industry as a protectionist countermeasure partially backfired. It pushed the Japanese into the production and import of larger (and more profitable) cars—a market segment in which U.S. manufacturers had previously been relatively unchallenged. This product market pressure reduced the U.S. industry’s share of the domestic market from 87% in 1974 to 79% in 1991 and dramatically reduced the profitability of the industry as well. But there is a flipside: U.S. firms came to adopt Japanese production techniques (e.g., “just in time” inventory controls and team-based production) and by 1994 had recovered to a 86% domestic market share in addition
to gaining an increased share of the worldwide market for automobiles. All three major firms, especially Ford, were highly profitable and stock prices recovered and advanced. (For example, in 1986 Ford stock traded between $9 and $16 a share; in 1996, between $27 and $37 a share.)

The connection between trade liberalization and the employee income effects described above is hotly contested. The most straightforward argument is that trade liberalization makes possible the substitution of lower-wage foreign labor for domestic labor (through the mechanism of locating, or relocating, plants offshore and importing goods back) and that this threat has become the means by which employers constrain employee wage demands.

The alternative explanation for the employee income effects is described in terms of "skill-biased" technological change—meaning that technological change drives the production process in a way that favors skilled over unskilled workers. Returns to education and experience are increasing and the income penalty associated with a lack of such skills is becoming more severe. Even on this account, however, trade liberalization plays an important role because heightened product market pressure is often the progenitor of technological change. It is not that the competitive pressure can, willy-nilly, produce technological advance. However, this pressure can make such discoveries and their rapid commercial application more valuable, both defensively (protection against inroads) and offensively (new markets to conquer). On both accounts, the liberalized trade regime plays a crucial role in intensifying the competitive regime that can dramatically affect firm profitability as well as reshape the wage structure.

IV. LABOR

The labor regime is an important background constraint on the adaptation to economic change, particularly affecting the degree of flexibility and rate of adaptation. Labor regimes operate in at least two ways which are relevant to economic change. The first is by regulatory imposition of standard terms on wages and conditions of employment, for example: protection against layoffs or arbitrary dismissal; restrictions on maximum
workhours (at least provisions for overtime pay); and mandatory fringe benefits. In all of these direct impositions, the definition of “employee” entitled to protection is itself a critical question. The second regulatory method is by grant and protection of bargaining endowments, that is, the right to organize and bargain collectively under a statute such as the National Labor Relations Act. Instead of direct protections, the employees are given bargaining endowments that would enhance their collective capacity to contract for such protections with the employer. Not only would such endowments make it easier for employees as a group to formulate tradeoffs between wage and non-wage amenities, but they would strengthen employees’ capacity to insist on a sharing with stockholders of the transition costs associated with economic change.

One of the remarkable features of the U.S. regulatory landscape has been the changes that did not occur in the labor law regime. Despite the greater employment instability associated with the 1980s takeover movement (at least in popular perception if not always in fact) and the instability that continues with the white collar layoffs of the 1990s, the labor regime has remained stable. The particular regime is one that accords employers great flexibility in responding to changing economic circumstance. First, there has been no substantial regulatory limitation on firms’ ability to fire workers on a retail or wholesale basis. Although dismissal rights against firing for invidious reasons (e.g., reasons of race, gender, or age) have been enhanced, the principle that the implied labor contract permits dismissal for the firm’s self-defined economic motives remains firm. This employment flexibility has been enhanced by the firm’s continuing capacity to hire “temporary” workers or “contract” workers who are not necessarily covered by legislative protections for “employees.” Thus, the firm can quickly change the size and character of its workforce in response to changing economic circumstances.

Second, there has been no augmentation of bargaining endowments that would make it easier for employees to contract for additional protections against the costs of economic adjustments, or even to contract for additional compensation in light of the additional economic risks borne by employees. For example, legislative proposals that would forbid the replacement of
strikers by temporary workers and that would give employees a choice of union representation through a consent solicitation rather than an election, both failed in the Congress.\textsuperscript{14} The importance of bargaining endowments is borne out by the experience of the airline industry in the post-deregulatory era. Because most of the major carriers were unionized, employees were relatively well insulated against wage reductions and layoffs, despite the rise of non-unionized new entrants that made existing labor contracts non-economic. In many cases, employees were able to exchange concessions (which often consisted of foregoing future wage increases and the agreement to perform work in a more efficient manner) for equity participation in the airline. Similarly, the issue of part time employees could be contracted in the 1997 contract dispute at UPS only because the collective organization of the UPS workforce made an economic struggle over the issue possible.

A liberalized trade and labor regime are reinforcing. Firms that face greater actual and potential worldwide competition (or worldwide opportunities) from a liberal trade regime may perceive greater pressure to cut costs. Obviously, wages to marginal workers cannot be cut, but inframarginal workers may be squeezed out. And of course, there are feedback effects to one firm's attempts to gain a competitive advantage through cost cutting, as firms try to leapfrog one another in that regard. A flexible labor regime opens up many avenues to labor cost reduction: downsizing, changing the nature of the production process (through automation, for example, or other capital-intensive production), and a "just in time" labor force through a temporary or contract work force (versus an "inventory" of full-time workers not fully engaged at many moments). Such measures not only respond to the changing competitive conditions, but they also intensify the competitive situation in the next round.

V. CORPORATE GOVERNANCE

The third element of the legal regime that underpins the New Economic Order is the corporate governance regime, which

\textsuperscript{14} See Gordon, supra note 1, at 1531-32.
affects the rate that a firm’s response to changing competitive conditions; this in turn affects the competitive environment itself. A key change that emerged in the 1980s was the greater exposure of the managerial team to evaluation by capital markets, because capital market signals, stock prices in particular, provide a future-oriented measure of the firm’s economic performance. Accounting reports of current earnings provide valuable information and are the most common alternative measure of performance. However, even putting aside the manipulability of accounting data (at least in the short run) by astute management, accounting reports are an incomplete measure of managerial performance. Accounting results measure and report on prior performance, today’s return on yesterday’s investments and strategic choices. Stock prices, by contrast, reflect the market’s judgment about future returns on current and future expected investment and strategic choices. Information about prior performance becomes relevant to judging how the firm responds to changing competitive circumstances. Moreover, performance measurement through stock market judgement is quick: something that will affect returns two years hence will be rapidly impounded into current stock prices.

Similarly, other signals about product market performance may be hard to interpret and in any event may reflect more about the firm’s past than its future. Is a sales decline the result of a business cycle fluctuation that should quickly reverse itself, or a deterioration in comparative product quality? Do higher (or lower) profits predict future trends? Moreover, a once-successful firm can live off its accumulated capital for many years before poor product market performance delivers the fatal blow. All of this is to say that stock price signals carry more news quicker than summary product market signals; a firm whose managers feel the necessity to respond to capital market signals will move quicker and will adapt more rapidly to a changing competitive environment.

This analysis finds a link between capital market responsiveness and economic success in the current worldwide economic environment, based on the argument that adaptability to changing competitive conditions is now especially valuable. The skeptic might point to alternative corporate governance regimes in Germany and Japan, for example, that eschew hostile take-
overs, yet result in economic prosperity. In those systems, managerial monitoring is performed by financial intermediaries or by other industrial companies with crossholdings. The recent sustained success of U.S. firms in the New Economic Order may challenge the functional equivalence of alternative governance models. That is a complicated question for another day. The short answer, however, is that in the absence of these monitoring alternatives in the U.S. system, capital market responsiveness is essential. For reasons of politics and history, stock ownership in the United States was fragmented and dispersed; the recent patterns of institutional ownership and activism are still quite limited in their monitoring capacity.

The skeptic may also complain that the available capital market signals—stock prices—are too imperfect to use as a cornerstone for a corporate governance system. Stock prices are indeed imperfect signals, noisy both because of private information withheld from markets for competitive reasons and because of market volatility that may result from the flaws in the way markets (and market participants) assess information. Market spasms like the several hundred point gyrations of the Dow-Jones Industrial Average during late October 1997 are just the visible manifestation of the confounding potential for prices that fluctuate enormously around “intrinsic value.” But this is only an argument for placing some governor on the most extreme forms of capital market responsiveness. As I have elsewhere stated, “one part of the corporate governance design problem is devising a regime that will encourage managerial responsiveness to the real economic information carried in stock prices while avoiding hair-trigger arbitrage transactions based on the gap between stock prices and alternative measures of value.”

The present corporate governance regime is a long way from the worrisome hair-trigger.

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The changes in corporate governance that triggered and now sustain managerial responsiveness to capital market signals are a complicated series of events involving changes in the legal regime, ownership patterns, and contractual arrangements. The

15. See Gordon, supra note 6, at 513.
“reorientation” of corporate governance to take stronger account of capital market signals has been supported by what might be called a “norm cascade,” a pronounced and reasonably sudden shift in the attitudes and local culture of many corporate actors, particularly board members. One very important question is whether the corporate governance regime that sustains capital market responsiveness will survive the managerialist counterpressures for a regime more protective of their autonomy.

The current regime has its genesis in the newly emerging takeover activity of the 1960s, spurred by increasing efficiency and liquidity in capital markets. As stock markets developed, stock prices became an increasingly reliable measure of the value of the firm under current management and poor stock market performance became an increasingly reliable signal of an arbitrage opportunity. Market liquidity meant that, for many firms, a takeover entrepreneur could successfully make a general offer to acquire a controlling or majority interest, a “tender offer.” To curb sudden, short-fuse offers that could perhaps capture firms at a bargain price, Congress in 1968 adopted the Williams Act. The Act established minimum time periods for tender offer activity designed to give targets and target shareholders time to reflect and respond, and which also gave a regulatory role to the SEC. One of the important ironies of this legislation is that the resulting regulatory framework legitimated hostile tender offers as an accepted business practice and opened the way for hostile takeover activity by a broader array of market participants.

As the hostile takeover movement expanded in the 1970s, managers increasingly looked to state legislatures for protection. Managers built lobbying campaigns around the alleged threat to in-state jobs and “corporate citizenship.” Not far in the background, however, was management’s threat to shift the situs of incorporation to a more accommodating forum. Wave after wave of anti-takeover legislation was adopted in response to this "managerialist" pressure. From the perspective of enhancing managerial exposure to capital markets, the crucial legal move was the 1982 U.S. Supreme Court decision Edgar v.

Mite, which struck down many such state measures as having been preempted by the Williams Act and as impermissibly burdening interstate commerce. Important judicial decisions in Delaware permitted a restrained form of managerial resistance to hostile takeovers that slowed down the process, raised the costs to an acquirer, and perhaps discouraged some bids—but left ample room for a determined acquirer willing to pay a significant market premium for the target.

If the U.S. Supreme Court turned up the takeover heat in 1982, its 1987 decision in CTS Corp. v. Dynamics Corp. of America turned it down. In evaluating state anti-takeover statutes, the Court decided that measures operated through the state law framework for corporate governance were not preempted by the Williams Act and did not impermissibly burden commerce. The CTS decision opened the way to state corporate law regimes that were increasingly favorable to the resisting target in a contested takeover bid. The state legislative law changes also affected judicial decisions, possibly from the same race-to-the-bottom competitive concerns that influenced the legislature. Courts may also have been responding to growing social concern about the disruptive effects associated with a high level of takeover activity. One manifestation of this was the Delaware Supreme Court's 1989 decision in Paramount Communications, Inc. v. Time, Inc., which substantially expanded the board's freedom to reject a hostile bid.

During this period of growing capital market activity and shifting legal rules, there was another development with broad implications for the corporate governance regime: the rise of institutional investor ownership and activism. Throughout the

18. See id. at 640.
19. See, e.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (stating that defensive tactics must be proportional to the threat posed by hostile bids to legitimate interests of corporations and shareholders); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985) (noting that in sale of control, defensive tactics must be aimed at obtaining the highest value reasonably available for shareholders).
21. See id. at 81-86.
22. See Gordon, supra note 1, at 1529-32.
23. 571 A.2d 1140 (Del. 1989).
24. See id. at 1150-53.
1970s and 1980s, the institutional share of the U.S. equity market increased from approximately 20% (1970) to 35% (1980) to 50% (1990). During the course of this same period, institutional behavior also underwent a significant change: away from the Wall Street rule of "support management or sell the stock" to various forms of activism. This activism displayed itself in what may be considered a three-dimensional array. Along what might be conceived of as the "structural/firm specific" axis, institutional investor activism varied from measures designed to enhance governance structures across a wide range of firms (for example, outsider-director dominated boards, or separation of the positions of board chairman and chief executive officer) to measures targeted at specific firms deemed to be underperforming (for example, efforts to replace senior managers or to shift business direction). Along the "active/passive" axis, institutional activism varied from initiation or support of a proxy battle (very active); identification of underperformers and agitation for board response (somewhat active); identification of underperformers and letting others act (active-passive); abstaining or voting against the incumbent board without initiating a proxy contest, a "just vote no" strategy (passive-active); or sale into a premium offer (passive). Along the "formal/informal" axis, institutional activism varied from shareholder proposals in the management proxy statement requesting specific board action (formal) to jawboning senior management about issues of concern (informal).

The ability of institutions to coordinate their activities was enhanced in 1992 by SEC rules that exempted institutional investor corporate governance activity from time-consuming and costly regulatory clearance. Though there is a debate about whether institutions have generally been able to target specific firms in ways that improve performance, even what might be called the "latent activism" of institutional investors who will support a control entrepreneur in a proxy contest or takeover

25. See BRANCATO REPORT, supra note 5, at 42.
bid at an underperforming firm is itself an important new element of the corporate governance regime.

Changes in the governance structure have also been supported by private contracting. For example, executive compensation is increasingly tied to a firm's stock market performance via generous stock option grants that help align interests of managers and shareholders. The changes in governance have also been supported by a significant shift in the attitude of directors, a norm cascade in favor of managerial responsiveness to capital market signals. The pressures brought by these governance changes pushed directors in this direction. Even judicial decisions that give boards significant (but not unlimited) latitude to resist hostile takeover bids may nevertheless push directors toward market-favoring norms, because enhanced judicial scrutiny of takeover defenses to a premium bid usefully buttresses the board's independence from management. Moreover, the period provided cautionary tales of directors who acquiesced too long to underperforming senior managements, imperiling the survival of the firm, at IBM and GM, for example. These stories also contributed to a norm shift from a governance regime responsive to capital market signals.

However, governance regimes are not necessarily stable. There is significant counterpressure from managements who want insulation from such capital market scrutiny. When such counterpressure expresses itself as lobbying for legislative action, it often strikes a sympathetic chord with legislatures that would also like to satisfy constituent concerns about the greater employment instability that the New Economic Order appears to create. Capital markets seem harsh; backsliding is easy. Thus, although there is now much greater consensus than during the 1980s about the efficiency-enhancements of merger and acquisition activity, the legal barriers to hostile acquisition have become more formidable. Many states have adopted statutes that permit a board to "just say no"; pivotal Delaware is arguably tending in that direction in its elaboration of directors' duties. Corporations are putting in place a new species of poi-

28. These are elaborated in Gordon, supra note 6, at 514-16.
29. The Delaware trend started with Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989) and has continued with Unitrin v. American General
son pill, the "deadhand pill," which requires the approval of continuing directors for its dismantling. This is an effort to discourage hostile bids by giving the incumbent board the power to "just say never."

Institutional investor ownership and activism, although it promotes capital market responsiveness, is not sufficient. Legal rules matter because they set the framework within which institutions (and catalytic forces like control entrepreneurs) can act. Moreover, it may be that institutions are most effective in their "latent activist" mode—providing votes to resist managerial overreaching or to support an insurgent in a proxy battle, and as a willing seller to a hostile bidder.

Thus, legal rules that close down the market in corporate control would significantly muffle capital market signals (and undermine the existing corporate governance regime) for three reasons. First, such a change would eliminate the direct replacement of management through a premium hostile bid, and perhaps more important, management’s fear of being replaced. It would weaken the connection facilitated by control markets between stock price signals and real economic decision making.

Second, the change would diminish institutional effectiveness, especially insofar as the institution’s power comes from its ability to support (or credibly threaten to support) a control entrepreneur. Rules against hostile bids would reduce the catalytic presence of control entrepreneurs. Free rider problems make it very unlikely that institutions would step up to more vigorous engagement in monitoring, and a strategy of latent activism would lose most of its force.

Third, closing down the control market would undermine directorial monitoring of management. The collegial setting of a board makes it hard to hold management to account; an active control market reminds directors that if they do not perform the task, their positions too are at risk. This stiffens directorial willingness to insist on management accountability. There is already evidence that directors are not as effective in an era of constrained control markets in removing management at under-

Corp., 651 A.2d 1361 (Del. 1995). For a more in-depth discussion on this trend, see Gordon, supra note 6, at 522-31.
performing firms, and are especially slow, relative to control markets, where underperformance affects an entire industry sector. Further constraints on control markets would exacerbate these trends.

The consequence is not trivial. Such corporate governance changes will, especially over time, reduce the speed with which changes in the competitive environment are integrated into decision making by a firm. If the success of U.S. firms in the global economy is at least partly attributable to the corporate governance regime, the present prosperity may well be at risk.

VI. THE APPOMATTOX OF VIRGINIA CORPORATE LAW

Seen in this light, recent developments in Virginia law, especially the statutes that sweepingly empower target boards, are not salutary. The case that illustrates this is WLR Foods, Inc. v. Tyson Foods, Inc. In late 1993 and early 1994, Tyson Foods, the national poultry producer, made a series of overtures to acquire WLR, a Virginia-based producer of chickens and turkeys. Tyson's offer was $30 cash for stock previously trading in the teens. Notwithstanding the very substantial premium, the WLR directors insisted the company was not for sale. They were able to rely on a series of provisions in the Virginia corporate law to erect a barricade of defenses, including a flip-in poison pill, behind which it could "just say no."

In response to the board's resistance, Tyson launched a $30 per share tender offer. Under the Virginia Control Share Acquisition Statute, Tyson could not vote a controlling interest without prior approval of a majority of the "disinterested" WLR shareholders. The WLR board undertook a number of actions to enhance the probability of shareholder rejection of Tyson as a

33. See id. at 1176-77.
34. See id.
35. See id. at 1177.
possible controlling shareholder. The board set the record date to minimize voting by those who acquired WLR stock after announcement of Tyson's interest. Certain inside directors who held approximately eleven percent of the WLR stock resigned as officers (though receiving a severance package that included lifetime health benefits). Under the federal court's somewhat questionable interpretation of the Virginia law, the resignations meant they were now "disinterested" shareholders and eligible to vote.  

Tyson lost the referendum.

The ultimate deal breaker, however, was the board's deploying of a flip-in poison pill with a 15% trigger that, unless redeemed, would impose a crushing financial penalty on the acquirer. The important corporate law question is the standard that governs the board's refusal to redeem the pill. The Virginia statute, at least as construed by the federal court, gives directors unusually wide latitude. Apparently this creates the test of a good heart but an empty head (good faith) in deciding how to respond to a hostile bid. Even more remarkably, under the federal discovery ruling in this case, Tyson could not make adequate inquiry about the information presented to the board, in particular, the substantive advice it received from its expert advisors, to test the "good faith" claim. The district court failed to understand that if even the "reasonableness" of the board's decision could not be challenged as such, evidence of unreasonableness would nevertheless bear on the good faith of the board's decision making. How else to know whether the board acted in "good faith" (rather than from a disabling con-

37. See WLR Foods, 65 F.3d at 1177.

38. Tyson's losing the shareholder vote was an unusual event, only partly expli-
clicable by the shift of the former officers to the "disinterested" column. Earlier in its history, WLR was a chicken growers cooperative. When it was organized as a corporation, the growers received shares and entered into supply contracts with the new entities. For many of the WLR shareholders, these contracts were much more economically important than the stock ownership. Tyson's threat, if any, was to displace these growers with lower cost producers (or to push for renegotiation of the contracts). This, rather than an inadequate stock price, was the threat of the Tyson of-

Moreover, many of the growers/WLR stockholders were concentrated in a specific region of Virginia, the upper Shenandoah Valley. The fact that votes would be known to management and the potential informal community sanctions were likely to have kept many potential dissidents in line.

flict of interest) except by inquiring into its decision making process?

Tyson retreated and the WLR shareholders have not prospered. Under incumbent management, WLR has underperformed both the industry and the stock market on earnings and share price, which is now as of March 1998 around $10 a share—against a tender offer price of $30.40

The Virginia anti-takeover statutes make for an unusually preclusive package. There is a Control Share Acquisition Statute,41 which, as described above, limits voting rights of a hostile bidder; an Affiliated Transactions Act,42 which limits the ability of a hostile acquirer to accomplish a freezeout merger after obtaining a majority of the target's stock; a poison pill statute,43 which permits defensive use of a shareholder rights plan entailing discriminatory treatment of shareholders; and a business judgment statute,44 which establishes "good faith" as the care level for directors.

The business judgment statute, which is the most lethal part of the package, shows how the desperation of the anti-takeover lobby can severely distort corporate law norms. In the interpretation in WLR, the business judgment statute supplants the common law business judgment rule, at least in tender offers,45 and nothing in the statute limits its application to that setting. Although the Virginia corporate law often follows the Model Corporate Act, the Virginia legislature intentionally omitted the Model Act's formulation of the business judgment rule requirement that a director exercise "the care of an ordinarily prudent person" and act in a manner "he reasonably believes to be in the best interests of the corporation."46

41. See VA.CODE ANN. §§ 13.1-728.1 to -728.9 (Michie 1993).
42. See id. §§ 13.1-725 to -727.1.
43. See id. § 13.1-646.
44. See id. § 13.1-690.
only obligation under the Virginia statute is to “discharge his duties as a director . . . in accordance with his good faith business judgment of the best interests of the corporation.” The requirements of “ordinary care” and “reasonableness” are gone; “good faith” remains. Moreover, the poison pill statute explicitly makes issuance and redemption of a pill subject to the standard of the business judgment statute. On a “good faith” standard, a board should be able to stand fast behind a “just say no” defense, virtually immune from judicial scrutiny. This goes well beyond the directors’ duties statutes in other states, which permit boards discretion (under the customary care level of judgment) to take into account the “long term interests” of the corporation and its shareholders or the interests of other constituencies. It seems that a the board of a Virginia corporation can resist a hostile bid for any reason (short of a disabling conflict of interest) and need not even defend the reasonableness of its actions against any metric. This is troublesome not only for the total surrender of the duty of care, an Appomattox, but also because of the impact on the duty of loyalty. A process that never samples the air of justification may miss uncovering the odor of corruption.

* * *

One metaphor for corporate law, in the takeover area, is the statutes and the court decisions as the control rods in a nuclear power plant. A regime of total laissez-faire in these matters may lead to reactions that are too intense and to a pattern of business reorganization that could be too disruptive, too error prone, and too costly. But a regime that is too protective will shut the reactor down. As I have argued previously, this will deaden the corporate governance regime and enervate the competitive responses that have led corporations to success in the New Economic Order.

47. VA. CODE ANN. § 13.1-690(A) (Michie 1993).