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Five Decades of Corporation Law: From Conglomeration to Equity Compensation

Richard A. Booth

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IT is an honor to speak to you today as the first Martin G. McGuinn Professor of Business Law. Before I launch into my short talk, I would like to thank Marty McGuinn and his family for endowing this chair. It means that Villanova Law School will become a magnet for students and scholars of business law nationwide. I would also like to thank Dean Mark Sargent and the faculty of the law school, who chose me for this chair over some stiff competition. I am truly grateful to have my work recognized by such an august group and for the vote of confidence implicit in my appointment to this position. I trust that I will be able to live up to it. Finally, I would like to thank my wife Christine and my sons Charlie and Turner. Although it was not too difficult for me to decide that I wanted to join this faculty, I could not have done so without their love and support.

My subject today is the recent history of corporation law from about 1950 to the present. Although the phrase "corporation law" may sound a bit odd to many ears, the phrase corporate law is too generic. There are all sorts of laws that apply to corporations. Corporation law, on the other hand, is what might be called the "constitutional law of corporations." It is the law that governs the internal affairs of corporations. Every state has its own corporation law. The United States sports fifty-one varieties of corporation law—not including the territories—more flavors than Baskin Robbins and almost as many varieties as Heinz. But because of historical accident—indeed historic accident—it is the corporation law of Delaware that applies to most publicly traded corporations.1

1. In 1875, New Jersey became the first state to adopt a general corporation law that permitted any business to incorporate. By the 1890s, New Jersey had established itself as the jurisdiction of choice for big business, in part because its law permitted one corporation to own stock in another corporation and thus permitted the formation of so-called "trusts." Such combinations of companies in turn...
When I started law school in 1973, corporation law was more or less dead. As Dean Bayless Manning wrote in 1962:

[Corporation law, as a field of intellectual effort, is dead in the United States. When American law ceased to take the corporation seriously, the entire body of law that had been built upon that intellectual construct slowly perforated and rotted away. We have nothing left but our great empty corporation statutes—towering skyscrapers of rusted girders, internally welded together and containing nothing but wind . . . .

Those of us in academic life who have specialized in corporation law face technological unemployment, or at least substantial retooling. There is still a good bit of work to be done to persuade someone to give a decent burial to the shivering skeletons.²

I did not run across this passage until sometime after I had decided to focus my own intellectual efforts in the area (even though my first law school class on corporations was a pretty good indication that Manning was correct).³

II. THE 1970s

Although there are state law rules that govern the actions of directors and officers, the courts before the mid-1970s seldom found any violation, no matter how egregious the conduct. Many suspected Delaware of pan-
gave rise to antitrust laws. At the end of his tenure as governor of New Jersey, in his farewell speech to the state legislature after he had been elected President in 1912, Woodrow Wilson (with a good deal of prodding from Louis Brandeis) proposed a package of changes to the provisions of New Jersey corporation law that he saw as most abusive. That proposal came to be known as the Seven Sisters because it consisted of seven separate bills. Among other things, the bills forbade the formation of holding companies. See Joseph F. Mahoney, Backsliding Convert: Woodrow Wilson and the "Seven Sisters", 18 Am. Q. 71, 73 (1966) (detailing new corporate regulations). These changes to New Jersey law were adopted in 1913. See id. But Delaware had already copied New Jersey law, so most big New Jersey corporations simply reincorporated in Delaware. Thus, Delaware became the jurisdiction of choice for big business and has remained so ever since. See S. Samuel Arsht, A History of Delaware Corporation Law, 1 Del. J. Corp. L. 1 (1976) (tracing formation of Delaware corporate law).


3. In contrast, my second law school class on things corporate, Business Units II (taught by Marvin Chirelstein), was the single most important factor that inspired me to specialize in corporation law. I have heard other Yalies who teach in the area say the same. Although it now seems like a modest contribution to legal scholarship, the article that Chirelstein published with Victor Brudney of Harvard discussing how to allocate merger gains was groundbreaking. See Victor Brudney & Marvin A. Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 Harv. L. Rev. 297, 297 (1974) (arguing that "fair merger requires that gains generated by the combination should be shared by the two corporations rather than wholly absorbed by either"). Incidentally, the odd title Business Units (or BU as we called it) was a product of Legal Realism, reportedly coined by William O. Douglas.
dering to managers and controlling stockholders who could easily move the corporation's charter to another, more hospitable state if they became dissatisfied. This prompted Professor William Cary, a former chairman of the SEC, to publish a landmark 1974 law review article arguing that the states were engaged in a race to the bottom—a competition in laxity—and to propose a federal takeover of corporation law that would provide meaningful fiduciary standards.4

Short of a federal takeover, it was the hope of many reformers that federal securities law could fill the gaps in state law.5 Indeed, the SEC's catch-all antifraud rule—Rule 10b-5—seemed nimble enough to deal with most problems. Although federal securities law mandates disclosure to investors and does not create any fiduciary duties, it is easy in most cases to cast a claim in terms of disclosure. A stockholder can always say that if only she had known, she would have sold her stock or sued for an injunction.

The showdown came over going private.6 With the stock market in the doldrums from 1962 to 1982, many public corporations sought to buy

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4. William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663, 699-700 (1974) (calling for comprehensive federal standards, not simply extension of Rule 10b-5). For example, Cary cited Cheff v. Mathes, 199 A.2d 548 (Del. 1964), as a case in which the Supreme Court of Delaware permitted incumbent management to use corporate assets to defend against the unwanted advances of a would-be acquirer to the detriment of stockholder interests. See id. at 673-75 (discussing Delaware's "penchant in favor of management"). The race to the bottom was not original to Cary. Wilson and Brandeis made similar arguments sixty years earlier. The migration of New Jersey corporations to Delaware after the enactment of the Seven Sisters seems to prove the point. Although the race to the bottom sounds like a good explanation for the evolution of corporation law, several legal scholars have argued that it makes no sense. Why would a corporation want to incorporate in a jurisdiction distrusted by stockholders? That would tend to depress stock price and expose the corporation to takeover. Rather, a corporation should choose to incorporate in a state stockholders favor. And stockholders should favor a state with laws that afford stockholders rights where they matter without creating opportunities for obstructionist stockholders. See, e.g., Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U. L. Rev. 913, 920-21 (1982) (critiquing "race to the bottom" thesis).


6. See, e.g., Kaufmann v. Lawrence, 386 F. Supp. 12, 12 (S.D.N.Y. 1974), aff'd, 514 F.2d 283 (2d Cir. 1975) (denying appeal of injunction order against consummation of tender offer where appellant challenged action as amounting to "going private").
back their own stock. In some cases they resorted to merger with a shell corporation by which all of the public stockholders could be forced to take cash for their shares.\(^7\) It was like eminent domain for corporations. Never mind that some stockholders might not want to sell. On the other hand, why should going public be a one-way trip? And why should a corporation be able only to get bigger through merger?\(^8\)

Ironically, the worry in the 1960s was more about bigness than about stockholder welfare.\(^9\) Even the old soldier President Eisenhower had warned that the military-industrial complex was a threat to democracy. And the trendy subject in law school was antitrust. Looking back, it is odd that it was not apparent at the time that going private signaled the possibility that investors and managers might like the idea of smaller, more focused companies. By the mid 1980s, antitrust was more or less dead and the bust-up takeover was all the rage.

Nevertheless, critics argued that it was wrong for a controlling stockholder to buy back stock held by the public at bargain basement prices using the corporation’s money—let alone to force reluctant stockholders to sell. Presumably, insiders would propose such a deal only if they believed that the stock was worth more than the market price. And presumably, they would keep the gain for themselves. Besides, why should an investor be forced to give up a stock simply because insiders find it inconvenient to have public stockholders?

\(^7\) Before the 1960s, a stockholder almost always got stock in the surviving corporation. Although cash mergers were originally intended to afford flexibility in mergers involving companies with complex capital structures, one unintended consequence of permitting cash mergers was that they could be used to cash out minority stockholders. The first real cash merger statute was adopted by New York in 1936 to permit the cash-out of a minority interest where a parent utility owned ninety-five percent or more of the stock of a subsidiary—a so-called short-form merger. Delaware amended its general merger statute in 1967 to permit cash consideration, but it was not until 1971 that the Delaware courts clearly permitted the cash-out of minority stockholders other than in a transaction involving a short-form merger where the surviving corporation owns at least ninety percent of the stock of its merger partner. See David J. Greene & Co. v. Schenley Indus., Inc., 281 A.2d 30 (Del. Ch. 1971) (finding merger of subsidiary and parent not grossly unfair where parent held eighty-six percent of subsidiary’s common stock and value of offer closely approximated price at which subsidiary’s shares had traded on national stock exchange); Elliott J. Weiss, Balancing Interests in Cash-Out Mergers: The Promise of Weinberger v. UOP, Inc., 8 Del. J. Corp. L. 1 (1983) (exploring court’s efforts to balance interests of majority and minority shareholders in cash-out mergers). In other words, cash-out mergers were a recent innovation in the 1970s.

\(^8\) Even today, few states have statutory procedures by which a corporation may shrink itself.

\(^9\) Here, too, Brandeis was among the harshest critics of the way corporation law had evolved. See Louis K. Liggett Co. v. Lee, 288 U.S. 517, 565 (1933) (Brandeis, J., dissenting) (“Through size, corporations, once merely an efficient tool employed by individuals in the conduct of private business have become an institution—an institution which has brought such concentration of economic power that so-called private corporations are sometimes able to dominate the state.”).
To many observers, going private was yet another example of lax state law standards. Their hope was that federal securities law would come to the rescue. But in 1977, the United States Supreme Court decided in *Santa Fe Industries, Inc. v. Green* that Rule 10b-5 did not cover cash-out mergers in the absence of some kind of deception. Given that the cash-out merger in that case did not even require a stockholder vote, there was no need for any advance disclosure to the stockholders and no possibility of deception. The good news for Delaware was that federal securities law (as it stood) would not supplant state law fiduciary duty. The bad news was that Congress could change the law and might be inclined to do so if the cash merger or some other newfangled device was used to threaten an established company. After all, Congress had rather quickly passed the Williams Act in 1968, regulating the conduct of cash tender offers, after one senator declared that: "[T]oday, there are those individuals who seek to reduce our proudest business into nothing but corporate shells. They seize control of the corporation with unknown sources, sell or trade away the best assets, and later split up the remains among themselves."

It was six months (to the day) after the decision in *Santa Fe* that the Delaware Supreme Court handed down its decision in *Singer v. Magnavox Co.*, holding that there was a business purpose requirement for mergers. Delaware had dodged the bullet of federal takeover by affording stock-


12. See id. at 476 (stating that "statute provides a cause of action for any plaintiff who suffers an injury as a result of deceptive practices touching its sale or purchase of securities") (internal quotations omitted).

13. 113 CONG. REC. 857 (1967) (statement of Sen. Kuchel). Although the original bill sought to discourage hostile bids, the Williams Act was more neutral, focusing instead on disclosure and setting certain ground rules, both of which measures were ostensibly designed to protect target stockholders, but both of which also afforded the target company more time to defend itself. See Piper v. Chris-Craft Indus., 430 U.S. 1, 22-24 (1977) (discussing Williams Act); Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 58-59 (1974) (same). See generally Schwartz, *Federalism*, supra note 5, at 564 (explaining that "statute purports to be neutral with respect to tender offers, trying neither to discourage them, nor to tip the balance in favor of one side or the other").

14. 380 A.2d 969 (Del. 1977). The court held that "a Delaware Court will not be indifferent to the purpose of a merger when a freeze-out of minority stockholders on a cash-out basis is alleged to be its sole purpose." See id. at 979. What is ironic is that if *Singer* had been on the books, presumably *Santa Fe* would have been decided the other way. The clear implication was that federal securities law depended on state law. Following *Santa Fe*, the federal courts looked to state law to determine the contours of fiduciary duty not only for mergers, but also for insider trading, takeover defenses and virtually every other issue that came before them under federal securities law. That would give rise within a few years to the odd spectacle of the SEC appearing in the Delaware courts to plead its case.
holders new rights to challenge mergers. 15 I do not claim here that Delaware was motivated by the threat of federal legislation to change its law. Indeed, Singer was a quite principled decision. But Singer was a mixed blessing for Delaware. It meant that, in Delaware, a plaintiff could challenge a merger by incanting the mantra of "no business purpose." Every merger was thus reviewable by the courts. 16 And the smallest investor could potentially hold up a deal simply because he wanted to keep his shares.

III. The 1950s

Stockholders would soon see their new-found rights as more burden than benefit. 17 To see why, we must go back in time to 1952 and the birth of Modern Portfolio Theory—MPT for short. (I have always thought the name a bit odd. I do not think there was any ancient portfolio theory.) Harry Markowitz—who later won a Nobel Prize for his work—showed that investors could reduce risk without any sacrifice of return by investing in a diversified portfolio of stocks (or other securities). 18 For investors, getting the same return for less risk was like finding the Holy Grail.

It is not surprising that the MBAs of the 1950s figured they could apply Markowitz's ideas at firm level to assemble a portfolio of companies. It stood to reason that a conglomerate corporation composed of many different individual businesses would be less risky as a whole than the sum of its parts. When one division faltered, another would likely pick up the slack. The earnings of the whole would be relatively stable even if there was turmoil below. Stock price should rise and capital should be

15. This is not to say that the motivation for Singer was overtly political. It was a perfectly principled position for the Delaware courts to rule that a stockholder could not be done out of his investment except for a valid business purpose. Although the immediate threat to Delaware's supremacy had been averted, Santa Fe was likely an important factor in prompting the American Law Institute to undertake the Principles of Corporate Governance, which many in the practicing bar also came to view as a threat in the late 1980s.

16. Moreover, if a merger was found wanting, the remedy was quite generous. Rescissory damages gave the plaintiffs the value of what they would have had if the merger had never occurred. See Lynch v. Vickers Energy Corp., 429 A.2d 497, 501 (Del. 1981) (ordering damages equal to value of stock at either time of resale or judgment). And that encouraged even more litigation. In short, Singer was a noble experiment, but it was ill-conceived and badly executed.

17. I am not aware of any event studies that seek to quantify market reaction to either Singer or Weinberger, but I would guess that the market reacted negatively to Singer and positively to Weinberger.

18. See Harry M. Markowitz, Portfolio Selection, 7 J. FIN. 77, 77 (1952) ("Diversification is both observed and sensible; a rule of behavior which does not imply the superiority of diversification must be rejected both as a hypothesis and as a maxim."). Markowitz taught at the business school at University of California, San Diego at the time.
A conglomerate company with a high price-earnings (P/E) ratio could absorb a business with a low P/E ratio and magically increase its value. In addition, the tax code made dividends unattractive for stockholders. So, what else was one to do with excess cash other than acquire other companies? And it did not hurt that most companies based CEO


20. For example, if a conglomerate with a P/E of 10 acquired a business with a P/E of 5, the earnings of the acquired business when added to the earnings of the conglomerate would add twice as much to the value of the conglomerate as had been the value of the acquired company. In other words, the acquired company was worth twice its market value to the conglomerate. Or so the thinking went. The gain depends, however, on an implicit market inefficiency, namely, that the market is fooled into applying the P/E ratio of the conglomerate to the acquisition even though the market had applied a lower P/E to the acquisition as a stand alone company. As one might guess, analysts eventually figured out that they could apply different discount rates to different lines of business. And the trick stopped working. See generally Burton G. Malkiel, A RANDOM WALK DOWN WALL STREET 61-68 (6th ed. 1996) (detailing conglomerate boom and eventual bust); see also David Horowitz & Reese Ehrlich, Litton Industries: Big Brother as a Holding Company, in David Mermelstein, Economics: Mainstream Readings and Radical Critiques 91, 95 (1970) (describing how “creating a glamour image [was] a major preoccupation of conglomerate managements”). For an example of the more fine-grained approach to valuation, see Cede & Co. v. Technicolor, Inc., No. 7129, 1990 WL 161084 (Del. Ch. Oct. 19, 1990).

21. Prior to 1984, individual income tax rates were almost confiscatory in the upper brackets. Immediately before the 1986 tax act, the top individual rate was fifty percent, and it had been as high as ninety percent before 1969, when it was reduced to a mere seventy percent for the years up to 1981. The tax rate on capital gains, however, was only half that of the rate on ordinary income (and for a time was only forty percent of the rate on ordinary income). One tax-motivated tactic that evolved in the 1960s was for the owners of several separate corporations to contribute their shares to a new corporation and take back shares in the new corporation that would be roughly equivalent to a closed-end mutual fund. Indeed, the resulting entity was often called a swap fund. Before 1967, such a deal could be done tax free—without the recognition of gain at the time of the contribution to the swap fund, even if the contributed shares were appreciated—under IRC 351. See I.R.C. § 351 (West 2008). In 1966, Congress added Internal Revenue Code section 351(e) in order to treat such transactions as sales rather than tax-free contributions to capital, somehow intuiting the gain that comes from diversification. See Marvin A. Chirelstein, Tax Pooling and Tax Postponement—The Capital Exchange Funds, 75 YALE L.J. 183, 214 (1965) (explaining “development of the capital exchange fund as a device for the avoidance of federal tax on dispositions of appreciated securities”).

22. This is not to suggest that such acquisitions were usually or often made for cash. To the contrary, most such deals were stock for stock deals because that deal structure both permitted “pooling” accounting and eliminated the need for the acquirer to depreciate goodwill after the acquisition. See Claire A. Hill, Why Financial Appearances Might Matter: An Explanation for “Dirty Pooling” and Some Other Types of Financial Cosmetics, 22 DEL. J. CORP. L. 141, 161-63 (1997) (explaining accounting methods for business combinations). Nevertheless, extra cash was vital to conglomerate mergers because it gave the acquiring company the capacity to absorb the target.
incentive compensation on the growth of earnings or assets or both. Finally, it was more fun for management to run a bigger company. These were the days of synergy and Bucky Fuller. The book *Small Is Beautiful* would not be published until 1973.

IV. The 1980s

It is difficult to argue with the logic of conglomerate mergers in isolation from alternative investments. But a conglomerate company is really a glorified closed-end fund. Why would an investor choose such an investment over an open-end mutual fund? Closed-end funds can—and often do—trade at a discount, whereas an open-end fund cannot. One answer (among several) is that mutual funds were quite expensive in those days. Sales loads were high—often eight percent or more. And the fund itself paid full retail commission rates when it traded shares in its portfolio—without even a volume discount—because brokerage commissions were fixed by the New York Stock Exchange. All that began to change on May Day 1974, with the abolition of fixed commissions for institutional investors. In addition, the advent of IRAs in 1974 and 401(k) plans in 1982 (and the extension of IRAs in that same year) created a huge new market for mutual funds.

As brokerage commissions fell, it became almost costless to assemble a diversified portfolio of stocks or to change the mix at will. In contrast, it was quite costly for a conglomerate to buy and sell whole companies. In other words, it is much cheaper for investors to diversify than it is for companies to diversify. From the investor point of view, acquisitions aimed at firm-level diversification (and other firm-level hedging strategies) are a waste of money. (There is no reason to buy Lunchables if all you want is cheese and crackers. Who needs the boloney?)

Moreover, there is no reason for a mutual fund to buy stock in a conglomerate. So as mutual funds grew in size, demand for conglomerate

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24. See E.F. Schumacher, *Small Is Beautiful* (1973) (advocating against theory that "bigger is better"). While antitrust was the hot concentration among law students in the mid 1970s, small business was the trendy career goal among business students.

25. Fixed commission rates were abolished for *individual* investors on May 1, 1975.

26. A conservative estimate is that it costs five to seven percent of deal value for one business to acquire another, whereas brokerage commissions today average about one cent per share for institutional investors or about 0.04% of a $25 stock.

27. This also explains why the SEC has resisted the "fund of funds" concept. Although there may be some sense in diversifying one's holding of funds in order to avoid the risk of bad fund management, there is not much else to be gained by holding multiple funds with the same investment goals.
stocks fell. The net result was to set up a competition of sorts between conglomerates and mutual funds.

Finally, in October 1979, the Federal Reserve Board—following the advice of Milton Friedman—shifted its focus from interest rates to money supply and permitted interest rates to float. Floating interest rates gave rise to an active market for bonds. And that permitted Mike Milken and Drexel Burnham to create a market for junk bonds. Soon, investors developed a taste for leverage. With leverage, a company can increase shareholder returns. Although leverage also increases risk, diversified investors are indifferent to risk if it is justified by the prospect of higher returns. A diversified investor does not much care if a few companies go broke if all seek to maximize return. For every company that goes belly up, another will perform better than expected. Only the average matters. So investors had another reason to reject conglomerates. Not only were they unnecessary for investors who could achieve diversification more cheaply, but a conglomerate is also a bad bet because the constituent companies have no incentive to be focused.

In short, as mutual funds (and other institutional investors) gained market share, demand for conglomerate stocks fell. As the market price of conglomerate stocks fell, arbitrage set in. A bidder using cash from junk bonds could buy a conglomerate, sell off the component companies to pay back the loan, and exit the deal with a nice profit. It was a perfect financial storm, and conglomerates were going down with the ship. In effect, the market came to demand companies that were lean, mean and focused.


30. This is somewhat at odds with the Modigliani & Miller thesis that (contrary to popular belief) leverage does not change the total value of a firm. See Franco Modigliani & Merton H. Miller, The Cost of Capital, Corporation Finance and the Theory of Investment, 48 AM. ECON. REV. 261, 261-71 (1958) (explaining how capital structure is irrelevant to firm value). Modigliani and Merton’s point is that for a single firm, the value is the value no matter how one divides it up. The addition of debt to the capital structure causes equity to become riskier and precisely offsets the potential benefits of leverage (other than tax benefits). But Modigliani and Merton did not consider the effects of investor diversification (and other hedging strategies), by which investors are able to avoid the downside of leverage. See Ronald J. Gilson & Charles K. Whitehead, Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets, 108 COLUM. L. REV. 231, 247-51 (2008) (discussing real benefits of risk management).

Meanwhile, back in Delaware, Singer had become a liability. To be sure, once a bidder gains control, the bidder can do what it wants with the target. So it is not clear that minority stockholders must be cashed out. But if minority stockholders cannot be cashed out, the bidder must share its eventual gain (if any) with those that remain. And it is difficult to plan a deal if you cannot predict the return. Moreover, if the target company remains publicly traded—subject to complete control by the bidder turned parent—target stock price is likely to be depressed. The bidder may thus be precluded from securing financing or later offering target shares to the public as a way of exiting the deal. The bottom line is lower returns and fewer deals.32

at discount even in 1960s); see also David J. Denis et al., Global Diversification, Industrial Diversification and Firm Value (Aug. 2001), available at http://www.mgmt.purdue.edu/centers/ciber/publications/pdf/99-005.pdf (documenting increasing trend in global diversification). Of course, there are always exceptions; in the case of conglomerates, General Electric is a good example. See Patrick Gaughan, Mergers, Acquisitions and Corporate Restructurings 23 (3d ed. 2002).

32. Although an undiversified minority stockholder might argue that it is undesirable to encourage more deals anyway, a diversified stockholder would likely favor a rule that maximizes the number of deals (and minimizes legal challenges including appraisal rights) as long as a majority of the minority favors the deal. So, it is no surprise that the majority vote required for mergers was gradually reduced from the traditional two-thirds of both sets of stockholders to a majority of votes cast by the target stockholders casting a vote. The problem is that if we permit cash-out mergers, insiders can use the same technique to get rid of minority stockholders and take the company private. Although that may be a good deal for the stockholders who get cashed out, it may also be tempting for insiders to run down the price of the company to do the deal on the cheap. We could set up a rule that prohibits insider mergers. But such a rule effectively presumes that all such mergers are fraudulent and eliminates as buyers those who know the business best—a classic case of throwing the baby out with the bathwater.

There are two possible answers to this conundrum. One is competition: outside bidders are free to bid for the company and presumably will do so if the proposed price is too low. The other is that minority stockholders can assert their appraisal rights in such cases. Delaware adopted the former rule in Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985). The Model Business Corporation Act (MBCA) has adopted the latter rule. In essence, MBCA 13.02 confines appraisal to deals in which there is a danger of insider overreaching. Delaware has also taken the position that dissenting stockholders in an appraisal proceeding may be entitled to a control premium in addition to the appraised value of their stock. See Richard A. Booth, Minority Discounts and Control Premiums in Appraisal Proceedings, 57 BUS. LAW. 127, 128 (2001) (arguing that “the addition of a control premium is inconsistent with settled corporation law and good policy that there is no basis for the assumption that market prices routinely build in a minority discount”). See generally Bradley R. Aronstam, R. Franklin Balotti & Timo Rehbock, Delaware's Going-Private Dilemma: Fostering Protections for Minority Shareholders in the Wake of Siliconix and Unocal Exploration, 58 BUS. LAW. 519, 522 (2003) (proposing amendment of “appraisal statute to require parent corporations to pay all minority shareholders, including those not exercising their appraisal right, the court’s appraised value if it exceeds what the corporation paid in the short-form merger”).
Mercifully, Singer was overruled in 1983 by Weinberger v. UOP, Inc., which did away with the business purpose requirement.\(^{33}\) In effect, Weinberger granted a license to cash out minority stockholders at a fair price.\(^{34}\) It is no coincidence that the takeover market exploded following Weinberger, or that stockholders enjoyed unprecedented returns for the next seventeen years.\(^{35}\)

V. The 1990s

Weinberger was not the end of the matter. As one might guess, the CEOs of potential target companies went looking for ways to defend themselves against the bust-up takeover.\(^{36}\) It is easy to see how a corporate raider can make money from a bust-up takeover. Imagine buying an old book filled with fifty original photographs for $1,000 and selling off the framed individual prints for $100 each. Better still, recall the scene in the movie Wall Street in which Gordon Gekko's legal henchmen describe how they plan to sell off the pieces of Blue Star Airlines in order to pay back the banks, much to the dismay of Bud.

In theory, a conglomerate could break up on its own initiative by spinning off less profitable divisions to its own stockholders, who then would enjoy the gain. And it has become common practice to do so—sometimes to avoid takeover. In contrast, a hostile bidder has little choice but to sell off assets. No one would buy a company in order to give away the pieces.

\(^{33}\) 457 A.2d 701, 715 (Del. 1983) (holding that business purpose requirement "shall no longer be of any force or effect"). The trial court ruled in one opinion that the goal of making a profit constituted a business purpose. No one would propose such a deal but for the prospect of making a profit. So, one could argue that the business purpose rule had been gutted because by definition, every deal has a business purpose. On the other hand, and in fairness to the Weinberger trial court, the business purpose might inhere in the fact that minority stockholders entail costs and expenses that can be avoided by cash-out. In other words, the prospect of profit comes not from commandeering the portion of the profit that would otherwise go to the minority, but rather by the prospect of an increase in the aggregate profit from the deal that would be precluded by the existence of a public minority interest.

\(^{34}\) Weinberger also installed more effective protections for stockholders, requiring arms-length negotiations in parentsubsidiary mergers. Since that time, Delaware has been quite vigilant about stockholder rights. Although defendants win most of the time, plaintiffs prevail in many cases.

\(^{35}\) Although there has been much debate about whether corporate law really matters in the sense that parties are largely free to negotiate around most rules, it seems clear that cases such as Weinberger that announce new rules of global application make a difference. See generally Bernard S. Black, Is Corporate Law Trivial?: A Political and Economic Analysis, 84 Nw. U. L. Rev. 542, 544 (1990) (developing "triviality hypothesis," which argues that state corporate law "does not prevent companies—managers and investors together—from establishing any set of governance rules they want").

\(^{36}\) See Martin Lipton, Greenmail, Bust-Up Takeovers—A Discussion Memorandum, N.Y.L.J., Sept. 7, 1984, at 1, 2 (discussing protective shield against "greenmail, bust-ups and front-end loaded bootstrap takeovers").
The result was the invention of the poison pill and the passage of an array of state takeover statutes. The Delaware Supreme Court approved the pill in 1985. And the United States Supreme Court approved state takeover statutes in 1987, rejecting the argument that they were an undue burden on interstate commerce or impermissibly inconsistent with federal tender offer law. But none of this would change investor demand for focused companies that seek to maximize returns. That genie was out of the bottle. Moreover, the evolution of investor tastes changed the rules for all companies—not just conglomerates.

The preference of the market for focused companies has profound implications for the CEO. It is relatively comfortable to run a conglomerate and generate an adequate return for stockholders. So in the 1950s and 1960s, the CEO was happy to get a nice salary and a bonus. But it is not so comfortable to assume the risk of generating an ever-increasing stock price. Diversified stockholders do not really care if a few companies go broke trying to maximize stockholder value because other companies will do even better than expected and make up the difference. So it is no surprise that turnover among CEOs increased dramatically in the 1990s. Nor is it surprising that CEO pay began to increase dramatically and to take the form of equity.

The problem is how to motivate managers to take more risk and even to break up their own companies when necessary. But why would a CEO


38. See CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 94 (1987) (finding that Indiana Act did not conflict with Williams Act and any effect on interstate commerce "is justified by the State's interests in defining the attributes of shares in its corporations and in protecting shareholders"); see also Edgar v. MITE Corp., 457 U.S. 624, 646 (1982) (invalidating Illinois Act under Commerce Clause).

39. Indeed, many economists in the 1950s and 1960s had rejected the idea that individuals were motivated to maximize wealth in favor of the idea that most individuals merely sought adequate wealth, an idea that came to be known as satisficing. See Herbert A. Simon, *Theories of Decision-Making in Economics and Behavioral Science*, 49 AM. ECON. REV. 253, 262-65 (1959) (exploring behavior and goals of business firms).


41. See Jensen & Murphy, *supra* note 40, at 23-34 (examining trends in executive remuneration). Although many commentators argue that the growth in golden parachutes and equity compensation is attributable to changes in the tax code in 1984 and 1993, respectively (each of which were intended to set limits on their respective subjects, but both of which came to be viewed as safe harbors), it is equally plausible to view these events as catalysts that changed the focus of compensation committees, which then began to focus on the other advantages of such devices.
want to bust up (or leverage up) his own company? It might be necessary to avoid takeover, but how could it be rewarding?

The question may sound rhetorical, but it is not. How could we make it rewarding for a CEO to bust up his own company? The answer is equity compensation—stock and stock options. Suppose that Acme Fireworks announces that it will spin off its struggling gopher ball division. The market price of Acme skyrockets because each stockholder will now have two stocks instead of one. You can keep both, or sell one but not the other. You have exactly what you had before, but now you also have a choice. As Martha Stewart would say, that is a good thing. Choice alone must be worth something. Moreover, the new and focused gopher ball company is likely to do better. It might even become the target of an acquisition. Although Acme will soon be a smaller company, the price of its stock is higher. So the CEO will make money on his options even though he has shrunk the company. If it makes sense for a company to grow by acquiring other companies, presumably the market will reward that strategy too. In other words, options work whether a company is growing or shrinking. Pretty nifty.

But wait. There’s more. Options have another important side benefit: they induce companies to repurchase their own shares in order to control for the dilution that comes from the exercise of options. For example, in 1997 it was reported that Microsoft used cash equal to two-thirds of its earnings to repurchase shares.\(^{42}\) The news was shocking to many stockholder activists who saw it as more evidence of insider avarice. But buybacks fix one of the basic problems that lead to takeovers—the practice of hoarding cash and reinvesting it in uneconomic expansion. As one commentator put it, “...[I]dle cash is the devil’s workshop.”\(^{43}\) To be sure, dividend rates remain low today. But that is an illusion. The fact is that corporations distribute much more cash to stockholders these days.\(^{44}\) And they do so by repurchasing shares from the least happy stockholders, which further supports stock price. Thus, companies that use options have evolved into something like open-end mutual funds.

This is not to say that someone sat down and thought this through quite as I have explained it here. Options have been around for a long time, and various people have long been aware of their potential. But the widespread implementation of options is testimony to the fact that it makes sense to use them as an incentive tool. Options are not only available to CEOs, but they are also available to many other positions within the company. In fact, options are becoming increasingly popular among employees at all levels.

\(^{42}\) See Roger Lowenstein, *Microsoft and Its Two Constituencies*, WALL ST. J., Dec. 4, 1997, at C1 (noting that huge portion of Microsoft’s earnings were “consumed in the selling-cheap-buying-dear stock-option treadmill”).


Their expanded use may have been prompted by the advent of the golden parachute in the 1980s. But it is enough that options happen to work.

So it is not at all surprising that equity compensation exploded during the 1990s and that successful CEOs took home big bucks. In the 1990s, the CEO assumed the risk of failure in an effort to maximize stockholder value. And failure meant takeover or the sack. No one who understands the situation would take such a job without the promise of a big reward. And if the goal is to generate gain for the stockholders, who would not insist on a piece of the action? I am not sure why this seems shocking or wrong to so many corporate activists. It may be that it is undiversified investors who show up at the annual meeting to collect the box lunch. But there is long tradition in the business world of working for a piece of the pie. Nowhere is that more standard than in law firms where an associate may work ten years for a partnership—though the compensation in the meantime can be pretty attractive. Why should we assume that the CEO of a public company must be a hired gun who works for the stockholders in exchange for a fixed fee? Why would we even want that arrangement? It makes more sense to think of the CEO as a partner in the business—one who stands to share the gain, if any.

The essential idea behind the golden parachute is that it will make the CEO indifferent to takeover. See Richard A. Booth, Is There Any Valid Reason Why Target Managers Oppose Tender Offers?, 14 SEC. REG. L. J. 43, 60 (1986) (noting, however, that "golden parachute could be so attractive that management would be encouraged to sell out too quickly"); Michael C. Jensen, The Takeover Controversy: Analysis and Evidence, 4 MIDLAND CORP. FIN. J. 6 (1986), available at http://ssrn.com/abstract=173452 (analyzing controversy surrounding takeovers and discussing use of golden parachutes); see also Jensen & Murphy, supra note 39, at 27-29 (discussing evolution of golden parachute).

The total amount of officer compensation as a percentage of corporate income has remained quite constant since 1960. Jensen and Murphy argue that this fact indicates that compensation committees have mindlessly stuck with the same formulas in granting options even though growth in the value of the stock market generally has had the effect of dramatically increasing the dollar value of compensation. But the evidence is also consistent with the idea that executive compensation is more about dividing up the corporate pie between outside stockholders and officer-stockholders. See Richard A. Booth, Executive Compensation, Corporate Governance, and the Partner-Manager, U. ILL. L. REV. 269, 296 (2005) (suggesting that corporation should be thought of "as a partnership between management and investors"). On the other hand, it may also be that the CEO commands a larger percentage of total officer compensation than was the case in the 1960s and 1970s. It is not clear that the jackpot model of compensation is a good thing. But that is largely an intramural matter that concerns the officers as a group.

Some commentators have argued that options have been overused to compensate lower level employees and that they should be reserved for those officers who can make a difference to stock price. See Jensen & Murphy, supra note 40, at 35-43 (discussing option component of pay package). That argument ig-
VI. THE 1960s

I have not said much about the sixties. But as they say, if you remember the 1960s, you weren’t there.

V. CONCLUSION

So what does it all mean? One answer is that our system of corporate governance (and incentive structures) is in much better shape than seems to be widely thought. I do not mean to suggest (as did Pangloss in Voltaire’s Candide) that we live in the best of all possible worlds. There is work to be done. For one thing, it is vital that we monitor executive compensation practices to assure that everyone plays by the rules. Timing and backdating in the grant of options are serious breaches of faith.

Yet another serious problem is that many investors remain undiversified—particularly those whose retirement plans are heavily invested in the shares of their own employer. By far the biggest losers in the collapse of Enron were the employees who saw their retirement accounts skyrocket and then vaporize because they were concentrated in Enron stock. If old-fashioned pensions are going to be replaced by portable accounts, we need to do better by employee-investors.

In addition, we need to rethink our model of who owns a corporation. The old idea that the stockholders own the company and that the CEO is a glorified employee is much too simplistic. In a world of diversified investors, it is the undiversified CEO who cares most about the company and who thinks most like an owner. A diversified investor does not much care about the fate of an individual company. But we cannot expect a CEO to think the same way. Nor would we want it so. Thus, the better view is that corporation law is about allocating returns between insiders and outsiders. The traditional view is that executive compensation is a

nores other significant benefits both of options and of being publicly held in general. Options give lower level employees a sense of ownership and a stake in the fortunes of the company, whether or not they can do much about stock price. Some recent legal scholarship has emphasized the corporation as a vehicle for team production in connection with products requiring inputs that cannot be withdrawn. See Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 VA. L. REV. 247, 265-76 (1999) (examining team production analysis of firm). If that view of the corporation is correct—and I suspect that generally speaking it is—then it is appropriate to reward lower level employees with a share of the gain from their efforts. In addition, the use of options to compensate lower-level employees induces them to focus on stock price as a continuous source of feedback. See Ronald J. Gilson & Charles K. Whitehead, supra note 30, at 256 (stating that “company receives virtually instant feedback through prices and periodic feedback through analyst reports, concerning its strategy and performance and that of its competitors, which would not be available to a private company”). To be sure, restricted stock could do the same thing. But restricted stock sends a mixed message. Options emphasize that for the employee, taking a job is an investment decision. See Richard A. Booth, Give Me Equity or Give Me Death - The Role of Competition and Compensation in Building Silicon Valley, 1 ENTREP. BUS. L. J. 265, 273-78 (2006) (discussing side-benefits of equity compensation).
mildly interesting duty of loyalty problem because it involves a structural conflict of interest. To the contrary, executive compensation is the central problem of corporation law. This insight gives new meaning to the idea of the monitoring board of directors. Legal scholars have argued for years that the board of directors should monitor the CEO. Who could disagree with that idea anyway? The point that seems to have been lost in the shuffle is that the board should not see itself as an advisory body. It is not the job of the board to support the CEO. Rather, the job of the board is to officiate the ongoing competition between outside investors and inside officers. Indeed, the board of directors as an institution makes little sense otherwise.49

Similarly, our system of securities regulation appears to be stuck in the 1960s. Among other things, we continue to rely on private securities fraud class actions as the primary form of enforcement.50 Individual recovery makes sense if a company makes a fraudulent public offering of overvalued stock. In such a case, the company should give back the cash. But it makes no sense in a world of diversified investors for investors to have a right of action against the company simply because the company fails to disclose bad news in a timely way to existing investors who hold stock that is already outstanding. In such a stock-drop action—as opposed to a fraudulent offering—a diversified investor is equally likely to be a seller as to be a buyer and thus is equally likely to gain as to lose as a result of the so-called fraud. Moreover, diversified investors gain nothing from stock-drop actions. Because the corporation pays, holders effectively reimburse buyers and sellers keep their gains. In other words, the system suffers from circularity akin to a game of musical chairs in that stock-drop actions ultimately do no more than transfer wealth among investors. Indeed, diversified investors are net losers to the extent of attorney fees and other costs of litigation. And the issuers who are targets of such actions see their stock drop in price by more than it otherwise would because the prospect of litigation gives rise to a feedback effect. When the issuer pays to settle the case, the payment further reduces the value of the company, which leads to a further decrease in stock price and a further increase in the potential for damages. In the end, a target company faces a higher cost of capital than it would in a world without securities fraud class actions. And, in some cases, it may face financial ruin. On the other hand, diversified investors may suffer genuine financial loss when insiders take advantage of nonpublic information for personal gain or when they damage the reputation of the company by failure to be candid with the market.

49. Cf. Jensen & Murphy, supra note 40, at 81 (stating that board must "manage the tensions between" capital markets and internal managerial organization).
50. See Interim Report of the Committee on Capital Markets Regulation (Nov. 30, 2006) at 78-80 (conducting cost-benefit analysis of shareholder litigation, commonly known as Paulson Report); Coffee, supra note 40, at 1542 (reporting that "majority of the total monetary sanctions recently imposed in the United States were obtained through private, not public, enforcement").
In such cases, stockholders have a real gripe and should have a remedy. The simple solution is for the courts to deem stock-drop actions to be derivative actions rather than direct (class) actions. By recasting stock-drop actions as derivative actions, the courts could in one stroke eliminate the glaring market inefficiency of circular recovery, lower the cost of capital for issuers, emphasize individual responsibility, induce boards of directors and gatekeepers to become more vigilant and reduce the need for criminal prosecution.51

The problem with securities fraud class actions is but one example of a larger problem with federal securities law. The larger problem is that the SEC, Congress and the federal courts remain focused on the idea that a reasonable investor is one who reads mind-numbing disclosure documents, chooses a few good stocks and then diligently participates in the myth known as corporate democracy. The fact is that a reasonable investor diversifies his portfolio over many stocks usually by investing in a mutual fund or through a pension plan. Indeed, by diversifying his portfolio, an investor can eliminate company-specific risk without any sacrifice of expected return. Indeed, one can safely say that it is irrational for an investor not to diversify. The iron law of investing is that more risk requires more return. Moreover, as investors come to understand the value of diversification, they will bid up market prices because they take less risk. That is a good thing for issuers. But it means that undiversified investors who pick a few good stocks end up overpaying. If some investors diversify, all investors must diversify. Thus, if federal securities law is meant to protect reasonable investors, it should focus on the interests of a well-diversified investor, at least where interests conflict. The upshot is that, generally speaking, our system of disclosure should be more oriented toward the wholesale market than the retail market.52


52. The growth of mutual funds and other institutional investors and the migration of investors to such investments also led to a decline in stock picking. While growing acceptance of the efficient market theory no doubt led many investors to eschew stock picking on the theory that you cannot beat the market consistently, it also stands to reason that as investors become more diversified, they have less reason to engage in stock picking based on detailed company-specific research. This raises important regulatory questions. See Utpal Bhattacharya & Neal E. Galpin, The Global Rise of the Value-Weighted Portfolio, AFA 2007 Chicago Meetings Paper 2 (Mar. 2007), available at http://ssrn.com/abstract=849627 (examining "how the investment community has accepted one of the fundamental insights of modern portfolio theory—diversification"); see also Martijn Cremers & Jianping Mei, Turning Over Turnover, Yale ICF Working Paper No. 03-26, AFA 2005 Philadelphia Meetings 23 (Nov. 2004), available at http://ssrn.com/abstract=452720 (finding that roughly three-quarters of trading is motivated other than by stock picking); Meir Statman et al., Investor Overconfidence and Trading Volume, AFA 2004 San Diego Meetings (Mar. 2003), available at http://ssrn.com/abstract=168472 (investigating overconfidence hypothesis and disposition effect). But see Martijn Cremers & Antti Petajisto, How Active is Your Fund Manager? A New Measure that
There remains one very difficult problem for corporation law to address: overvalued equity. Stock options have been criticized since the demise of Enron and other major corporations in 2001 as inducing risky behaviors on the part of corporate executives. The standard argument is that options induce CEOs to take big chances to increase stock price. Not so. CEOs are poorly diversified and risk averse. The real worry is that they will take too little risk on behalf of diversified stockholders. Options are a way of nudging CEOs to take more risk. But they do so only reluctantly, because even with options as the primary form of compensation, some safe growth is better than taking a big risk for a jackpot.

The real problem arises when stock price increases more than it should for whatever reason. If stock price is too high, the CEO will naturally seek to keep it from falling in order to maintain paper gains. Looking back on the most recent spate of corporate scandals, it seems clear that many—if not most—of the problems resulted from an obsession with meeting analyst expectations: making the quarterly numbers.

So the question is, how do we induce CEOs to decrease stock price when necessary? Some legal scholars who think that options are the problem have advocated that corporations use restricted stock as equity compensation. If anything, that would exacerbate the problem. With restricted stock, the CEO loses money when stock price falls. With options, there is no loss other than the lost prospect of gain. That can be fixed in part by indexing exercise price on the downside. But indexing addresses the problem of irrational exuberance only when it is market-wide. It does nothing to address the problem if the market attaches unrealistic expectations to an individual company. Ironically, the solution for that problem is to permit and even encourage the board of directors to re-price options, even though most observers see re-pricing as abusive.

Predicts Performance, AFA 2007 Chicago Meetings Paper (Oct. 3, 2007), available at http://ssrn.com/abstract=891719 (finding that more active managers of non-index funds outperform less active managers). For a treatment of trading frequency from a legal point of view, see Paul G. Mahoney, Is There a Cure for “Excessive” Trading?, 81 Va. L. Rev. 713 (1995); see also Lynn A. Stout, Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation, 81 Va. L. Rev. 611, 616 (1995) (exploring heterogeneous expectations model which “predicts that investors' asymmetrical expectations will inspire them to seek short-term profits by speculating on stocks they perceive as mispriced”); Lynn A. Stout, Reply: Agreeing to Disagree over Excessive Trading, 81 Va. L. Rev. 751, 755 (1995) (arguing that “it seems unwise (or even irrational) to ground analysis of securities markets solely on elegant, but often inaccurate, financial models built on the fragile assumptions of investor homogeneity and agreement”). Bhattacharya and Galpin also found that in the United States in the 1960s, about sixty percent of trading was motivated by stock picking. They also predict that the level of stock picking will continue to decline and stabilize at about eleven percent. See Bhattacharya & Galpin, supra.

53. See, e.g., Jensen & Murphy, supra note 40, at 44-49 (examining agency costs of overvalued equity).

54. See id. at 46 (noting that “even those who have sensed the problem have been unable to stop playing the game”).

55. See, e.g., id. at 57-59 (advocating switch to restricted stock).
The trick is to distinguish those situations in which re-pricing is appropriate from those in which it amounts to a gratuitous do-over. Here again, it is key to be clear that the board of directors should serve as a monitor for management, and not as a cheerleading team. If the board of directors behaves accordingly, the market can be trusted to judge the situation fairly.56

I could say more. But I think I have said enough.

56. Cf. Richard A. Booth, Stockholders and Stock Options—Malfeasance, Manipulation, Misappropriation or Not? (forthcoming) (manuscript on file with author). Prior to 2005 (but after 1995), FASB rules required the expensing of re-priced options, but not of newly granted options. Now that the FASB requires that all grants be expensed, there is no disincentive in the rules to re-price options, although the market may still react negatively. Compare Jensen & Murphy, supra note 40, at 26-27 (describing option re-pricing), with Jensen & Murphy, supra note 40, at 41-42 (describing disappearance of option re-pricing).