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0521022835 - Corporate Law and Economic Analysis
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Corporate law and economic analysis

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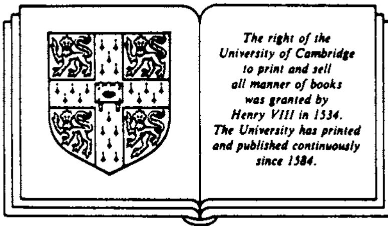

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New York Port Chester Melbourne Sydney

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Cambridge, New York, Melbourne, Madrid, Cape Town, Singapore, São Paulo

Cambridge University Press
The Edinburgh Building, Cambridge CB2 2RU, UK

Published in the United States of America by Cambridge University Press, New York

www.cambridge.org
Information on this title: www.cambridge.org/9780521360548

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First published 1990
Reprinted 1991
This digitally printed first paperback version 2005

A catalogue record for this publication is available from the British Library

Library of Congress Cataloguing in Publication data

Corporate law and economic analysis / edited by Lucian Arye Bebchuk.
p. cm.
Papers from a conference held at Harvard Law School, Nov. 1986,
and sponsored by the Harvard Law School Program in Law and
Economics.
Includes index.
ISBN 0-521-36054-4
1. Consolidation and merger of corporations – United States –
Congresses. 2. Corporate reorganizations – United States –
Congresses. 3. Corporation law – Economic aspects – United States –
Congresses. I. Bebchuk, Lucian A. II. Harvard Law School.
Program in Law and Economics.
KF1477.A75C644 1989
346.73´06626—dc20 89-32997
[347.3066626] CIP

ISBN-13 978-0-521-36054-8 hardback
ISBN-10 0-521-36054-4 hardback

ISBN-13 978-0-521-02283-5 paperback
ISBN-10 0-521-02283-5 paperback

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Introduction

Drafts of all the articles in this volume were presented in a conference at Harvard Law School in November 1986. The conference was sponsored by the Harvard Law School Program in Law and Economics. I wish to thank the John M. Olin Foundation which, through its generous grant to the Law and Economics Program, made possible the organization of the conference and the preparation of this volume.

The purpose of the conference and of this volume has been to put together research work at the frontier of the economic analysis of corporate law, especially work on the main policy questions now confronting this area of the law. The last decade has brought certain corporate transactions and arrangements to the forefront of public attention and public debate. At the same time, the last decade has been one in which a new mode of corporate law analysis has developed – one that uses the tools of economics to study the consequences and desirable features of corporate rules and regulations. The present collection should provide readers with a good sense of the power, current state, and future direction of work in economic analysis of law.

The first five articles in the volume focus directly on those transactions in corporate control and structure that have attracted much interest and controversy in the past decade – corporate takeovers, buyouts, recapitalizations, and reorganizations. These transactions have had great impact on the way in which capital markets – and the public companies traded in them – operate. The first two articles consider the economic motives and forces that underlie these transactions, whereas the following three articles discuss important policy issues raised by these transactions.

In Chapter 1, Oliver E. Williamson uses his well-known approach to the study of economic organization to explain the motives for the main corporate control transactions. Williamson's approach focuses on ex-

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amining which economic structures can best minimize the transaction costs involved in the functioning of complex economic organizations. From this perspective, Williamson analyzes the potential motives that underlie mergers, takeovers, and buyouts. He suggests that cost savings from horizontal mergers, if any, take the form of economies of scale, whereas those associated with vertical mergers usually take the form of transaction costs economies. He shows that conglomerate mergers can be interpreted from an internal capital markets perspective. The appearance of takeovers, he argues, is an outgrowth of earlier developments of which the conglomerate is a part. Finally, he seeks to explain leveraged buyouts as motivated by the opportunity for a more efficient use of financial instruments: Because the rational use of debt and equity depends on the characteristics of the firm's assets, a leveraged buyout can create efficiency gains in those cases in which the use of equity financing has become "excessive."

Reinier Kraakman offers, in Chapter 2, a different perspective on the motives for corporate acquisitions and restructuring. He explores the implications of the conjecture that discounted share prices are an acquisition motive for an important subset of recent takeovers. Share prices are discounted if they fall below reliable appraisals of the net present value of cash flows that target assets are expected to generate. Kraakman presents evidence of share discounts in closed-end funds, natural resource firms, and recent targets of acquisitions, buyouts, and recapitalizations. He proposes that share discounts can survive in today's acquisition market, that they are a plausible source of large premia paid to target shareholders, and that they can explain much financial restructuring among American firms. Two broad hypotheses, he suggests, might explain how share discounts arise. One is that investors rationally expect the managers of discounted firms to misinvest future corporate cash flows. The other is that share prices themselves are noisy or skewed. Kraakman suggests that the two hypotheses have divergent policy implications. He argues, however, that existing evidence does not enable selecting between these two accounts of discounting behavior.

In Chapter 3, Jeffrey Gordon examines the policy issues involved in dual class recapitalizations. Such recapitalizations, which produce classes of common stock with different voting rights, have become very important in recent years, as companies have sought to use them in defense against the takeover threat. Gordon argues that, as a theoretical and empirical matter, it seems likely that dual class recapitalizations reduce the wealth of public shareholders. Collective action and strategic choice problems in shareholder voting, he points out, may nevertheless lead to approval of proposals for such recapitalizations. He suggests that the

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traditional NYSE one share–one vote rule offered a unique and suitable bond against opportunistic renegotiation of the firm's capital structure that would lower the cost of capital. He therefore recommends that the SEC adopt rules that protect the NYSE's ability to offer this bond. Specifically, he argues that the SEC should bar the Amex and the NASDAC from listing the stock of a firm delisted by the NYSE for violating its traditional one share–one vote rule.

The volume's fourth chapter is by David D. Haddock, Jonathan R. Macey, and Fred S. McChesney. They argue that resistance to tender offers – even when such resistance is unlikely to facilitate an auction – may be beneficial to shareholders. Defensive tactics by target managements are likened by the authors to bargaining by agents for the owners of other assets that are traded in thin markets. Haddock, Macey, and McChesney argue that, under such circumstances, resistance enables sellers of assets to garner a greater share of the gains from exchange and thereby provides assets' owners with greater initial incentives to make value-enhancing investments with their assets. Finally, they take issue with the argument that, even if defensive tactics enhance the value of the firms that employ them, such tactics should be banned because they impose external costs on other firms by reducing the monitoring done by potential bidders.

In the volume's fifth chapter, I discuss the policy problems involved in Chapter 11 reorganizations and put forward a new method for dividing the reorganization pie among participants in reorganizations. Corporate reorganizations have always been the main way for handling insolvency problems of large corporations. The reorganization process, however, as thus far practiced, involves substantial efficiency and fairness problems: It produces substantial delay and transactions costs; it often results in an inefficient capital structure; and it frequently produces substantial deviations from participants' contractual entitlements. I then propose a method for addressing these problems: Participants in a reorganization would receive a set of rights with respect to the reorganized company's securities; these rights would be designed so that, whatever the reorganization value is, the participants would not have a basis for complaining that they are receiving less than the value to which they are entitled. Although the method is put forward as a basis for law reform, I show that it also can be used under the existing reorganization rules.

The next two articles expand the scope of analysis by considering not some particular corporate transactions, however important, but rather the market forces that shape such corporate arrangements in general. In Chapter 6, Frank H. Easterbrook and Daniel R. Fischel focus on the corporate arrangements established by corporate charters. A funda-

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mental question in corporate law concerns the extent to which companies should be free to shape the corporate arrangements governing them. To answer this question, Easterbrook and Fischel consider the various market forces and incentives that affect the decisions of those who design and change corporate charters. Their analysis leads them to adopt a "contractualist" position. Under this view, corporate law should not impose mandatory terms restricting the choice available to private parties; it should only facilitate the process of private contracting.

In Chapter 7, Roberta Romano considers the market forces that shape state corporate law. States compete over incorporating companies, and many of the rules governing companies are provided by the state in which the company is incorporated. A perennial issue in corporate law reform has been whether the competition among states has been a race to the top or a race to the bottom. Romano offers a synthesis of the existing learning on this competition. After summarizing the traditional positions on the issue, she puts forward her own approach, which is based on a transaction-cost explanation for Delaware's success in the competition among states. She then examines a controversial subset of state laws – antitakeover statutes – whose problematic place in corporation codes muddies the debate. She next reviews the findings of the empirical studies that have sought to arbitrate the state competition debate by employing financial econometric techniques. She concludes by discussing the implications for public policy of the new learning on state competition.

The last two articles further expand, in different ways, the scope of the volume's analysis. Whereas preceding articles in the volume examine how corporate behavior is affected by corporate-law rules, Chapter 8 by Saul Levmore discusses the effect of tax rules on corporate behavior. Taxes are usually viewed as distorting the "real" decisions of companies. Although Levmore agrees that taxes often have such distortionary effect, he attempts to show that there are instances in which the presence of taxes has a surprisingly "positive" effect on the operation of corporations. He first explores this positive role of tax law in the context of financing decisions, or the capital structure, of the firm. He suggests that the tax rules concerning the issue and distribution of debt and preferred stock discourage the very sort of managerial behavior that ought to be discouraged according to corporate finance theory. He then considers the positive role of tax rules with respect to large stock purchases by corporate acquirers. Here, the strategy picked up by the Internal Revenue Code can be understood, he argues, as designed to interfere as little as possible with the decision making of a target's shareholders in the face of a tender offer.

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Whereas all the preceding articles concern traditional corporations in which ownership is given to the investors of capital, the last article (Chapter 9), by Henry Hansmann, expands the discussion by exploring the forces shaping the ownership of firms in general. Hansmann examines the considerations that determine whether ownership of a firm is assigned to investors of capital or, alternatively, to some other group of persons, such as consumers of the firm's products or suppliers to the firm of a factor of production other than capital. He argues that ownership is generally assigned in a manner that tends to minimize total transaction costs for all persons who transact with the firm. This involves minimizing the sum of (a) the costs of market transactions for those who are not owners and (b) the costs of ownership for the class of persons who have ownership rights. The most significant costs of market transactions are generally those associated with monopoly and asymmetric information. The most significant costs of control are the costs of exercising effective oversight, the losses from managerial slack in the absence of effective oversight, the costs of collective decision making when owners' objectives are diverse, and the costs of risk bearing. After presenting his theory, Hansmann illustrates its usefulness by applying it to several specific alternative patterns of ownership: conventional investor-owned business firms; customer-owned retail, wholesale, and supply cooperatives; mutual life insurance companies; and worker-owned firms.

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Acknowledgments

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