Picking the Low-Hanging Fruit: A Short Essay for Michael Klausner

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I. INTRODUCTION

The articles that comprise this issue of the *Journal of Corporation Law* were first presented at a conference held at the Wharton School and co-sponsored by Wharton together with Columbia and Stanford Law Schools. The event was organized by my friend Peter Conti-Brown, to whom I am grateful for both the thought and the effort. Standing alone, the thought that the conference was warranted would have been extremely generous. However, anyone who has organized a conference knows that the idea for such events can be exciting, but what follows is an amount of work that had it been anticipated would cause them never to take place. For academics, irrational discount rates collectively fuel a lot of progress.

Peter also had the insightful thought for the conference's subject matter: to ask a younger generation of talented scholars to address some of my work and assess where it has had an impact, where it still has relevance, where I got it wrong in the first place, and how subsequent scholarship and changes in the areas of law and the related markets the articles addressed have advanced beyond my then near-sighted vision. Thinking about the event as it approached, I was both enormously flattered and then more than a little embarrassed. There are people who like being the center of attention; I'm not one of them.

Two more introductory comments are necessary. The first is to thank the contributors to this issue for having taken the time to write perceptive assessments and extensions of

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work that I am delighted people still read. Academics have only one asset: our time. The authors have made a gift of theirs for which I am deeply grateful.

The second is to say with pride that much of the work this issue's articles build on is not just mine. It is also Reinier Kraakman's, Bernie Black's, Chuck Sabel's, and Bob Scott's, and the list grows much longer if I go beyond just the articles in this issue. A central joy of being an academic, invoking Robert Putnam's evocative phrase, is exactly the opposite of "bowling alone."[1] It is to be part of an engaged and gracious community. For almost 40 years, I have consistently written with friends and gotten paid for it. If there is a better definition of winning the lottery, I can't think of it.

II. The First Round of Low-Hanging Fruit

Now to something substantive. Peter offered me the chance to repay my friends' generosity by imposing on them my thoughts about where our collective enterprise is going. To this end, I am stealing my title structure from an old Bayless Manning article: "The Shareholder's Appraisal Remedy: An Essay for Frank Coker."[2] Over the years, my friend and colleague, Michael Klausner, has teased me good-naturedly that my generation of business law academics got the first crack at the low-hanging fruit.[3] I have taken that comment to mean that my leaving practice for the academy roughly and luckily coincided with two parallel developments in corporate law scholarship—one expanding the methodology that could be applied in corporate law analysis and a second creating a new and exciting substantive area on which that methodology could be brought to bear. In this telling, my generation got the benefit of the scholarly opportunities these developments offered.

The methodological development was Michael Jensen's and William Meckling's 1976 publication of *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*,[4] which brought to bear the intersection of financial economics and agency theory on problems that were at the core of classical corporate law. These tools added a discipline to corporate law analysis that had been missing. Corporations acquire assets by purchasing them with cash provided by investors. Markets, in turn, value the corporation through the trading of the financial assets the corporation issued to secure the cash it used to acquire real assets. Investors want the value of the corporation to go up because that increases the value of the financial assets investors hold. And this is where corporate law enters the picture: it provides much of the framework for the effort to increase the value of the corporation. If the goal of corporate law is to facilitate increasing the corporation's value, then there is an obvious measure by which the legal rules should be assessed (although not necessarily the only one): does a particular rule operate to

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1. ROBERT D. PUTNAM, BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY (2001).

2. Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223 (1962).

3. Of course, Klausner went well beyond teasing, pointing out that some of the early work got it wrong. *See generally* Michael Klausner, *Do IPO Charters Maximize Firm Value? An Empirical Study of Antitakeover Protection in IPOs*, 17 J. LAW, ECON. & ORG. 83 (2001); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995); Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325 (2013).

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

increase the corporation's value?[5]

And it is here that another contribution from economists played an important role. It was around this time that financial data was becoming increasingly available and economists were increasingly analyzing that data. With methodologies developed by economists, legal academics had the potential to discern the relationship between rules or actions on the one hand and firm value on the other.

Part of Michael Klausner's clever tongue-in-cheek comment highlights that before financial economics was integrated into corporate law, legal academics had no way to assess the link between a legal rule and a corporation's value. It was not even clear that they thought of the value of legal rules in terms of the value of the corporation. With the discipline provided by financial economics, we could evaluate an old (and boring) body of law using new tools. In Klausner's framing, there was a lot of low-hanging fruit: did a particular rule create or destroy value? His characterization surely fits my early work. *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*,[6] that appeared in 1981, addressed takeover law through the prism of finance theory, economists' early empirical work, and agency theory to assess the law's impact on target company value. *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, written in 1983 and published in 1984, was built on just this strategy: to use financial economics to link what business lawyers did to the value of a transaction.[7] Reinier Kraakman's and my *The Mechanisms of Market Efficiency*[8] shared the same period and the same ambition.

To be sure, these articles aspired to more than academic arbitrage. They also sought to embed finance theory in the institutional structures in which the theory needed to operate, a point to which I will return. The timing here also provided some low-hanging fruit; finance itself was just then coming out of a period that led to the award of Nobel Prizes in Economics to the authors of work on the determinants of capital structure, portfolio management, capital asset pricing, and, a little later, option pricing. All rested importantly on a common set of perfect market—that is, institutionally thin—assumptions.[9]

But there was more than just new theory for young legal academics to apply; corporate law was also getting trendy. By the end of the 1970s, a question had taken form that, as Martin Lipton has nicely put it, set off the "Thirty Years War,"[10] which still rages as the conflict now has hit forty years.

Changes in corporate culture and the capital market took the hostile tender offer,

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5. *See* JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS (8th ed. 2013); FRANK H. EASTERBROOK & DANIEL FISCHEL, THE ECONOMICS OF CORPORATE LAW (1991) (applying economic theory to assess the impact of corporate law rules).

6. *See generally* Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981).

7. *See generally* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J.239 (1984).

8. *See generally* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

9. Franco Modigliani received the Nobel Prize in Economics in 1985; Harry Markovitz, Merton Miller, and William F. Sharpe in 1990; and somewhat later, Robert C. Merton and Myron Scholes in 1999.

10. Martin Lipton, *Will a New Paradigm for Corporate Governance Bring Peace?*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 15, 2015), https://corpgov.law.harvard.edu/2015/10/05/will-a-new-paradigm-for-corporate-governance-bring-peace/ [https://perma.cc/YV9V-4H6D].

previously a bit player, and brought it center stage.[11] The cultural shift is typically treated as having begun with International Nickel's 1974 hostile tender offer for Electronic Storage Battery. Not only was International Nickel a blue-chip player, but it was advised by Morgan Stanley, the first time a top-tier investment banker had represented a hostile bidder.[12]

The capital market changes that fueled the growth, and so the notoriety, of tender offers began with Michael Milken's and Drexel Burnham's development of the junk bond market in the 1970s, which opened the public debt market to non-investment grade borrowers. For our purposes, however, the critical element was that Drexel and Milken harnessed the junk bond market as a source of takeover financing. In the mid-to-late 1980s, more than half of the junk bond issuances were takeover related, which in turn could support large amounts of mezzanine financing by bank consortia; the availability of financing opened the takeover market to non-traditional acquirers and made much larger established companies potential targets.[13]

And here we return to the academic world and low-hanging fruit. At this point, corporate law had little useful to say about the central issue posed by hostile takeovers. State corporate statutes did not require the target's board of directors to approve a tender offer for the offer to go forward; the bidder's offer was made to the shareholders, with the result that target corporations were fully exposed to this form of capital market discipline. Framed favorably to management, individual shareholder choice presented a collective action problem: individual shareholders might accept too low a bid that effective negotiation could increase. Framed less favorably, management lacked the power to prevent shareholders from accepting an offer that threatened management's continued control. Regardless of the framing, that board approval was not required created a reciprocal demand from potential target managements for defensive tactics—strategies that would deter offers from being made without target board approval. The legal question posed by the tension between a premium bid made directly to the shareholders, and defensive tactics deployed by the board precisely to prevent the shareholders from accepting the premium, was the defining feature of Lipton's 30, now 40, year war. Who had the final say over whether an offer could go forward: the target shareholders to whom the offer was made, or the target board acting with neither shareholder approval nor explicit authority under the Delaware General Corporation Law? Was there a way that courts could distinguish protective from abusive defensive tactics?

This was the second element of the low-hanging fruit framing. The defensive tactics debate presented an opportunity for young academics to use the new theory to address the allocation of power within the corporation for the most important decision a corporation

11. *See* Ronald J. Gilson, *Catalyzing Corporate Governance: The Evolution of the U.S. System in the 1980s and 1990s*, 24 COMPANY AND SEC. L.J. 143 (2006).

12. Ron Chernow provides a good account of this critical change. RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE 598–602 (1990). *See also* BRETT COLE, M&A TITANS: THE PIONEERS WHO SHAPED WALL STREET'S MERGERS AND ACQUISITIONS 49 (2008). *See* NICHOLAS LEHMAN, TRANSACTION MAN: THE RISE OF THE DEAL AND THE DECLINE OF THE AMERICAN DREAM 100–82 (2019) (addressing the culture change more broadly and with a less favorable assessment).

13. *See, e.g.*, RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 20 (2d ed. 1995) (discussing the development of the takeover market); Bengt Holstrom & Steven Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 125–26 (2001).

would confront. My generation of academics largely concluded that the decision ultimately lay with the shareholders although with some disagreement about whether management should be able to slow down the process to secure a higher bid,[14] a view that met with some initial success in the Delaware Chancery Court, if in the end, not in the Supreme Court.[15] On the other side of the issue were active takeover lawyers, most prominently and most energetically led by Martin Lipton, who collectively devised and championed the most effective tactical and legal defense strategies.[16] The central points on both sides were made early and then repeated for decades.

The takeover literature presented another opportunity for legal academics to integrate economic theory into corporate law analysis. While legal academics did a good job of assimilating economic analysis into corporate law scholarship, economists were, and continue to be, slower in integrating an understanding of the relevant institutional infrastructure into their analysis. As Michael Klausner's work has shown, getting the infrastructure wrong badly undercuts the empirical results.[17] Early studies of the impact of adopting a poison pill are a good example. Some studies showed a small negative impact on firm value; others show a small positive impact. These results were puzzling: how could the impact of a pill, imagined to have so powerful as to block a hostile tender offer, be so small in either direction? John Coates, who had been a partner in one of the most prominent takeover law firms before becoming an academic, solved the problem by pointing to a critical institutional factor. A firm's board of directors can adopt a poison pill without shareholder approval; as a result, one could be adopted virtually overnight. In effect, any company that had not yet formally adopted a pill nonetheless already had in place a "shadow pill" that would have the same effect. The effect of a firm formally adopting a pill thus would have little effect on firm value; the pill's impact is already impounded into the share price of all firms.[18]

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14. For the early academic side of the argument, see generally Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Lucian Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Gilson, *supra* note 6.

15. The history of the case law is by now commonplace. For a law review exchange which presents both sides of the argument, see generally Ronald J. Gilson, Unocal *15 Years Later (and What We Can Do About It)*, 26 DEL. J. CORP. L. 491 (2001) (the academic side); Martin Lipton & Paul K. Rowe, *Pills, Polls and Professors: A Reply to Professor Gilson*, 27 DEL. J. CORP. L. 1 (2002) (the practitioner side); Ronald J. Gilson, *Lipton and Rowe's Apologia for Delaware: A Short Reply*, 27 DEL. J. CORP. L. 37 (2002). Then Chancellor Chandler provides a detailed judicial account of the issue's history in Air Products and Chemicals, Inc. v. Airgas, Inc., 16 A.3d. 48, 97–101, 108 (Del. Ch. 2011).

16. Martin Lipton presents the classic practitioner side of the argument in *Takeover Bids in a Target's Board Room*, 35 BUS. LAW. 101 (1979). Lipton's contribution was assessed in an issue of *The Business Lawyer* on the occasion of the article's 25th anniversary. *See* Martin Lipton, *Twenty-Five Years After* Takeover Bids in the Target's Boardroom: *Old Battles, New Attacks and the Continuing War*, 60 BUS. LAW. 1369, 1369 (2005).

17. *See, e.g.*, Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325 (2013).

18. *See generally* John C. Coates, IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271 (2000); Emiliano M. Catan, *The Insignificance of Clear-Day Poison Pills*, 48 J. LEG. STUD. 1 (2019). The problem, however, has not yet disappeared. Recent efforts at assessing the impact on firm value of defensive tactics have taken the form of comparing a sample of firms' Tobin's Q, a widely used measure of a firm's value creation, with each firm's governance rating based on an index comprised of positive and negative governance characteristics. These studies are surveyed in Merritt B. Fox et al., *The Core Corporate Governance Puzzle Contextualizing the Link to Performance*, 99 B.U. L. REV. 1995 (2019). These studies have been challenged by legal scholars who argue that some of the antitakeover variables used are treated

III. SCHRODINGER'S CAT AND COASE'S HORSE: A NEW CROP OF LOW-HANGING FRUIT

This account of major shifts in theory and changes in the capital market that created opportunities for legal scholarship for my generation of business law academics sets the stage for the core of my argument: that we are at a point where there is a new set of scholarly opportunities. We saw the trajectory of scholarship change markedly in the 1980s; new theory from financial economists and new facts created by changes in the capital market dramatically increased the level of capital market discipline of company performance. That new theory and those facts created Klausner's low-hanging fruit. In my view, we can see now the beginnings of a new crop, again opportunities for scholarship driven by the interaction of changes in theory and facts.

Readers may recognize in this interaction between changes in facts and changes in theory an echo of Kuhn's iconic work, *The Structure of Scientific Revolutions*,[19] and its pattern of punctuated equilibria with periods of normal science broken by inflection points. But my account also adds a more current overlay from Clayton Christensen's *The Innovator's Dilemma*[20] that shifts the cyclical pattern from science to economics. In Kuhn's account, a new paradigm that upsets normal science is not at first complete or broadly accepted, but rather starts a pattern for working out the rest of the new direction. In Christensen's account, the disruptive technology, rather than improving the existing method of production, reflects so sharp a break with existing products, and is of such low quality initially, that neither industry leaders nor their customers see the technology's potential. And because the market for the disruptive technology is small at the outset, a rational industry leader would ignore the innovation, sensibly concluding that the returns on the investment given its likelihood of success would not be worth the effort. The disruptive technology then takes root in secondary markets of no interest to the industry leaders, but unexpected developments in the technology later allow it to unsettle the industry core at the expense of the industry's leaders. New paradigms, and potentially disruptive technologies, are not yet ready for prime time when they first surface.[21]

Here is the simple and hardly original idea: scholarship cycles between facts and theory, sometimes in either direction. One way to frame it is as a tension between Coase's horse and Schrodinger's cat. The Coase turn of phrase asks how little a farmer could feed

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as having a negative effect on the measure of governance quality, but have no actual impact in the real world. *See generally* Emiliano M. Catan & Marcel Kahan, *The Law and Finance of Antitakeover Statutes*, 68 STAN. L. REV. 629 (2016) (evaluating the studies of antitakeover statute effects); Klausner, *supra* note 17. Unfortunately, it gets worse. More recent studies, using more sophisticated econometrics, show that certain takeover defensive governance attributes, such as having a pill formally in place, result in fewer takeovers. The authors stress, however, that their results are "atheoretic"; they offer no hypothesis to explain the link. *See* Jonathan M. Karpoff et al., *Which Antitakeover Provisions Matter?*, (Apr. 18, 2019) (unpublished manuscript) available at SSRN: https://ssrn.com/abstract=3142195 [https://perma.cc/K6P3-R9AD].

19. THOMAS S. KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTIONS (1st ed. 1962).

20. CLAYTON M. CHRISTENSEN, THE INNOVATOR'S DILEMMA: WHEN NEW TECHNOLOGIES CAUSE GREAT FIRMS TO FAIL (1997).

21. It is worth noting the use of the term "new paradigm," like that of "disruption," has come to be used far too loosely, the labels being used to claim at the outset a result without the development that both terms contemplate. The discourse could benefit from fewer trumpets. A further point is that neither account purports to address for what gives rise to the initiating innovation. For an effort to explore cyclical causation with respect to changes in corporate governance, see Ronald J. Gilson & Curtis J. Milhaupt, *Shifting Influences on Corporate Governance: Capital Market Completeness and Policy Channeling* (Working Paper, 2020).

a horse; the answer is revealed when the horse dies.[22] In the Schrodinger's cat thought experiment, the cat is both dead and alive until the cat's actual state is observed. In both, a new piece of information changes the path of analysis, although the effect on the horse is determinative, while the condition of the cat is not.

A simplified account of how finance turned into fancy microeconomics illustrates the point. In the 1950s, we knew a lot about the capital structure of real companies. There were detailed factual accounts of capital structure in different industries. What we did not yet have was much in the way of theory that explained why companies chose to finance their activities in different ways.

Then, in 1958, Miller and Modigliani published their first irrelevancy article.[23] They rigorously showed that in the absence of transaction costs (defined as the equivalent of perfect markets), capital structure and dividend policy—the core of what a Chief Financial Officer did and the advice investment banks were paid to provide the CFO concerning—did not matter. A cycle of facts and then theory followed. Despite what would subsequently be a Nobel Prize-winning contribution, capital structure did not turn out to be irrelevant, something Miller acknowledged 30 years later.[24] Companies that were run by CEOs and CFOs who had studied Modigliani's and Miller's work in graduate school, in some cases with the authors themselves, continued to have different capital structures. Academics then spent 40 years discovering why, when perfect market assumptions were relaxed, capital structure could matter. This was especially true with respect to the costless information assumption. For example, capital structure, by creating incentives that management valued because of their private information and by supporting bonding, could credibly reveal information that company executives knew but markets did not.[25] Work progressed from facts to theory, then back to facts and back to theory, and so on.

A different fact-theory cycle builds on the previous, but now dealing with capital market disciplinary techniques that fueled the defining, if repetitive, debate in corporate law and governance for the last 40 years. This cycle starts, as discussed above, with Jensen's and Meckling's 1976 article. Building on the incentive and bonding versions of Modigliani's and Miller's work,[26] the article places capital structure explicitly in an

22. I confess to not having been able to locate the citation to the comment I attribute to Coase; the readers' help would be appreciated. For now, I'm giving Coase the same benefit of the doubt that is given to Mark Twain. While Twain is given credit for the comment that "history does not repeat itself but sometimes it rhymes," there is no evidence that he ever said it, but it does sound like something he would have said. For Coase, I understand the quip to be a nice way of criticizing the highly mathematical turn of economics. Like Twain's characterization of history, the horse joke sounds like something Coase would have said. The editors did track down a Coase joke about horses (quoting Ely Devons in 1999) that "If economists wished to study the horse, they wouldn't go and look at horses. They'd sit in their studies and say to themselves, 'What would I do if I were a horse?'") for which I am grateful. It is, however, a different joke although also stressing the importance of empirical observation.

23. Franco Modigliani & Merton Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

24. Miller stated that, "Looking back now, perhaps we should have put more emphasis on the other, upbeat side of the 'nothing matters' coin: showing that what *doesn't* matter can also show, by implication, what *does*." Merton H. Miller, *The Modigliani & Miller Propositions After Thirty Years*, 2 J. ECON. PERSP. 99, 100 (1988).

25. *See* Bengt Holmstrom & Jean Tirole, *The Theory of the Firm*, 1 HANDBOOK OF INDUS. ORG. 63, 78–79 (1989) (surveying post-Modigliani and Miller influences on capital structure). Adding to the list of Nobel prizewinners in economics, George A. Akerlof, A. Michael Spence, and Joseph A. Stiglitz shared the 2001 prize for contributions in understanding the effect of asymmetric information in shaping markets.

26. Miller had moved to the University of Chicago just prior to Jensen arriving as a graduate student. LEHMAN, *supra* note 12, at 105.

agency, and so in a governance, context. The drill is by now familiar. Debt is hard edged and equity is soft edged. Agency costs lead to equity financed over-investment; if dividends aren't paid and free cash flow is used to inefficiently expand the enterprise, shareholders have limited recourse. There then followed more facts—the hostile takeover surge and the emergence of leveraged buyouts in the 1980s—and then more theory: Jensen's 1989 Harvard Business Review article with the attention-grabbing title: *The Eclipse of the Public Corporation*.[27]

The core of the leveraged buyout transaction was to turn equity into debt through a transaction that resulted, Jensen argued, in both much more powerfully incentivized operating management through their increased equity ownership, and much more powerful monitoring, the necessary complement to powerful incentives,[28] by the private equity firm because of the powerful inducement created by the firm's carried interest in the portfolio company's performance. In this account, better ownership structures and the resulting better corporate governance then leads to better performance, and so the ability to carry higher debt without the increased risk usually associated with a debt-heavy capital structure. Jensen thus presents a transactional and organizational road map for how a new organizational structure will displace public corporations.

The theory is in large measure internally consistent; it was the return to facts that presented the problem and fueled further scholarship.[29] What happened when scholars looked behind the theory to the actual transactions being done and their impact? I'll focus on a perceptive article by Steven Kaplan and Jeremy Stein, *The Evolution of Buyout Pricing and Financial Structure in the 1980s*.[30] The short answer is that the character of LBOs changed dramatically from the first half of the 1980s to the second. For buyout debt issued in the first half of the '80s, only one issue defaulted. For buyout debt issued in the second half of the '80s, 22 of 83 issues defaulted.

The problem wasn't the theory, it was facts. As Kaplan and Stein document, there was a major shift in transaction pricing and structure between the first and second half of the 1980s. Even the parsimonious version of this shift has three parts. First, the best deals were done first—the acquisition price to free cash flow ratio went up greatly between the two half decades. Buyers searching for targets could screen for possible transactions ranked by value. Second, the 'best deals being done first' pattern also applied to risk—second-half

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27. Michael C. Jensen, *The Eclipse of the Public Corporation*, 67 HARV. BUS. REV. 61 (1989).

28. *See* PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION AND MANAGEMENT 226–28 (1992) (discussing the "Monitoring Intensity Principle").

29. The most troubling inconsistency was the conflict within the theory underlying the structure of the private equity limited partnership as opposed to that of the portfolio company. Because the limited partner investors had no vote, something had to constrain the agency costs associated with the general partner's control. In Jensen's analysis, this was met by the ten-year term of the limited partnership: at the end of the term, the partnership had to be liquidated and the investors given their money back. If the performance was positive, the investors presumably would invest in the general partner's next partnership; but if not, the general partner would be punished by the investors withdrawing their funds from the general partner's management and not reinvesting. The need for a liquidity event to fund the return of investors' capital on liquidation, and the performance incentive associated with wanting the investors to reinvest the liquidation proceeds in the next partnership, served to constrain the private equity firm's agency problem. The difficulty with this account was the character of the necessary liquidity event. Whether by taking the portfolio company public (a "phoenix" IPO) or by selling it to a public corporation, a public company structure was retained, not eclipsed.

30. Steven N. Kaplan & Jeremy C. Stein, *The Evolution of Buyout Pricing and Financial Structure in the 1980s*, 108 Q.J. ECON. 313 (1993).

targets were in riskier industries than first-half targets, so higher variance companies were being leveraged in the second half, with the result that riskier debt was issued. Third, the character and the timing of the payouts to private equity firms shifted—much more of the acquirer's returns came through fees paid upfront, unrelated to post-transaction performance, thereby reducing the acquirer's post-transaction incentives to monitor.[31]

The lesson I take from this example is that the general debate over leveraged buyouts, which was initially categorical in nature on both sides, turned out not to be helpful. The analysis had to get past the early theory and look through to changes in transaction-level patterns. From there, we could work back up to theory. The conclusion: understanding how capital market discipline works requires starting with what a company does, not a high level transactional black box. And now comes the next generation of opportunities. Different company level problems are best addressed by different techniques of capital market intervention. And it follows that the same theory cannot explain the link between different explanations of why a target company is undervalued compared to its potential, and the capital market disciplinary tool that can address it.

IV. MATCHING CAPITAL MARKET DISCIPLINARY TECHNIQUES AND COMPANY PROBLEMS

The discussion to this point has focused generally on how cycles between theory and facts give rise to new crops of low-hanging fruit for academics to pick. More specifically, I've stressed the need to identify the link between the nature of the company-level problem and the capital market disciplinary technique that best addresses it. I now want to turn to what I am persuaded is an example of the current crop.

Fast forward to the current capital market disciplinary technique debate and one no less tendentious than those over defensive tactics and leveraged buyouts: the impact of activist shareholders on target company value. It's hardly a surprise that the activist phenomenon has resulted in a debate taking place at a decibel level not heard since the 1980s. In the 1980s, the fact that a large number of companies were just too big or too risky for a hostile takeover dampened, somewhat, the noise level. General Motors provides a good example. Over the 11 years from 1980 to 1990, the height of the hostile takeover period, GM spent $67.2 billion in excess of depreciation on research and development and capital expenditures. At the end of that period, GM had a total value of equity of $26.2 billion. In contrast, Michael Jensen points out that in 1985, the total equity value of Toyota and Honda was $21.5 billion,[32] during a period in which Toyota revolutionized automobile manufacturing by developing the *Kanban* (just in time) system.[33] General Motors could have purchased two successful automobile companies for significantly less than they spent on money losing investments. Commenting on Jensen's calculations, Seth Norton concludes that "GM spent a lot of money to make bad cars."[34]

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31. It was also the case that potential targets of LBO transactions could duplicate much of the LBO structure through a leveraged recapitalization without a change in control. *See id*. That left the central difference between an LBO and a leveraged recap the post-transaction governance structure—Jensen-style governance structure in the first, and public corporation governance structure in the second.

32. Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 858 (1993).

33. *See generally* JAMES P. WOMACK ET AL., THE MACHINE THAT CHANGED THE WORLD (1990) (describing the evolution of the Kanban system).

34. Seth W. Norton, *General Motors: Lost Dominance*, *in* INDUSTRY AND FIRM STUDIES 269 (Victor J. Tremblay & Carol Horton Tremblay eds., 4th ed. 2007).

General Motors, however, was not the subject of a hostile tender offer during this period, when it lost decades of dominance in the U.S. and world automobile market. To be sure, management changed in 1992 through a board revolt, the independent directors acting to remove Robert Stempel as CEO without the assistance of an activist-sponsored proxy fight. GM's performance was finally addressed as a result of its 2009 bankruptcy and a government-orchestrated restructuring. The capital market imposed no external discipline on GM; the downward trajectory of the company's long-term strategy was halted only by failure.[35]

In the activist era, however, the nature of the capital market disciplinary tools changed radically. Equity intermediation resulted in institutional investors typically owning a very large percentage of the outstanding stock of *all* large public companies. The result was that company size no longer presented a barrier to the imposition of capital market discipline. Rather than the activist having to leverage the target's balance sheet in order to pay for acquiring the target, the activist needed only to leverage the institutional investors' ownership in the target, which stands roughly at the same levels regardless of the target's size.[36] To be sure, the activist has to either persuade the existing board to accept its proposed strategy or, failing that, persuade the institutions to vote for the activist's slate in a proxy contest to replace all or a portion of the existing board (and so developed the pattern of activists presenting institutional investors with a 200 slide deck advocating for its strategy). Indeed, the sotto voce threat of a proxy fight has allowed activists with only single digit ownership to successfully negotiate for a board seat if the targeted company believed other institutional investors would be persuaded by the proposed strategy.[37]

The interesting question then, is whether different company problems are better addressed by different capital market disciplinary techniques: is the best approach to improving a particular company's performance that the target company be sold, or that a strategy change be imposed through an activist-led proxy fight but implemented by existing management, or addressed entirely by existing management because deeply firm-specific knowledge is necessary to first diagnose the problem and then design and implement a strategy to fix it, or, finally, is the company's problem no longer solvable, path dependency creating such barriers to change that change can come only, as with GM, through a Schumpeterian wave of destruction?

And so here are some current opportunities. I want to leave you with the thought that the academic cycle needs to turn back to more sharply focused theory and so a better sense

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35. Kirk Kerkorian threatened GM with a proxy fight in 2006 but terminated his interest when GM declined to go forward with a proposed alliance with Nissan and Renault. John O'Dell, *Dissident Leaves Board of GM*, L.A. TIMES, Oct. 7, 2006.

36. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 883 (2013) (describing the agency costs associated with equity intermediation); Ronald J. Gilson & Jeffrey N. Gordon, *Agency Capitalism: Further Implications of Equity Intermediation*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER (J. Hill & R. Thomas eds., 2015) (explaining the impact of shift in ownership structures of public corporations) on legal rules.

37. A classic example is Microsoft agreeing to add a director selected by Value Act Capital Management despite the fact that Value Act owned less than 1% of Microsoft's outstanding stock. While both Microsoft and Value Act publicly claim that the decision to put a Value Act representative on its board was completely friendly, the example also illustrates that in many cases the targeted company may give in without forcing a proxy fight. *See* Chira Ovide, *Activist Storms Microsoft's Board*, WALL ST. J. (Aug. 30, 2013), https://www.wsj.com/articles/microsoft-opens-board-seat-for-activist-shareholder-valueact-1377897865 [https://perma.cc/Z4M5-S8AA].

of what facts are important with respect to evaluating activist shareholders. As I've stressed, there is a great deal to gain from focusing on the link between the company level problem that is thought to require attention and the capital market disciplinary technique that is deployed to encourage change.

This is not the time to review the extensive and contested empirical evidence on the impact of activists;[38] however, a recent empirical study by David Larcker, Edward deHaan, and Charles McClure on the effect of activist campaigns on target company value illustrates the point.[39] Using a value-weighted, rather than the more commonly used equally weighted, measure of the long-term returns of their sample of activist targets, the authors report a surprising result: the long-term impact of activist interventions on target company shareholders is in the aggregate neither beneficial, as claimed by one side of the debate, nor detrimental, as claimed by the other. The conclusion: much ado about nothing.

For present purposes, I am going to assume the econometric results are correct. My concern about the study, and where the study fits with my thought about a cyclical scholarship process and a new crop of low-hanging fruit waiting to be picked, is not that the statistics are wrong, but that, like Kaplan and Stein demonstrated with respect to 1980s LBOs,[40] the hypothesis concerning the impact of activist shareholders must be much more specific to be helpful. From this perspective, there is more heterogeneity underlying the activism scenario. Empirical analysis necessarily must homogenize to some degree, however, more institutional analysis also might reveal more.

From this perspective, the authors' critical empirical finding is that returns for the firms that are targeted by activists differ depending on whether they are subsequently sold. In the authors' words, where targeted firms are subsequently sold, returns are "significantly positive and economically large," while the returns for nonacquired firms are insignificant.

So what are we to make of this? Without more, the arguments are no different than the 1980s debate about hostile takeovers that are often still made by the very same people. And here we all know the arguments; if we gave them numbers, we could shorten the debate by simply taking turns stating the number of the arguments on our side, like chess players announcing their move: Qe5.

The takeaway point—and what I think is a good example of Klausner's low-hanging fruit framing—is that the debate over the impact of the techniques through which the capital market imposes discipline on companies whose performance could be improved is too general to address the policy level question. Changes in the capital market determine the disciplinary techniques that are available: the development of junk bonds makes possible hostile takeovers; equity intermediation allows activist shareholders to undertake proxy fights. But what problems fit which disciplinary techniques? We need to recognize

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38. The literature is large and the reported results mixed. For a range of the outcomes and the methodology, see e.g., Lucian Bebchuk et al., *Dancing with Activists*, J. FIN. ECON. (forthcoming 2020) (discussing settlements when activists have a credible threat to capture board positions in a proxy contest and when incumbent directors have a strong reputation concern); John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door, The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 591–92 (2015); Alon Brav et al., *The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes,* 28 REV. FIN. STUD. 2723, 2764 (2015); Marco Becht et al., *Returns to Hedge Fund Activism: An International Study*, 30 REV. FIN. STUD. 2933, 2935–36 (2017). Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 735–43 (2007) presents the practitioners' assessment of the pro-activist empirical work.

39. *See generally* Ed deHaan et al., *Long Term Economic Consequences of Hedge Fund Activist Interventions*, 24 REV. ACCT. STUD. 536 (2019).

40. Kaplan & Stein, *supra* note 30, at 355–56.

the extent of heterogeneity in the phenomenon.

V. CONCLUSION: SOMETIMES PICKING THE FRUIT REQUIRES A LADDER

Not all fruit is low-hanging; sometimes it requires a ladder to reach it. I will conclude with a short account of a problem that has puzzled me for some time. While I think I am comfortable with how to frame the problem, I am not comfortable with how to resolve it. I'm missing a ladder.

Since the 1980s, prominent commentators have bemoaned the fact that the U.S. capital market is myopic, over-discounting the future and so favoring shorter-term, lower return projects over longer term, higher return projects.[41] That markets in some circumstances can be myopic is not implausible. Markets may lack information about the value of long-term projects that management has but cannot credibly disclose. In that circumstance, management may choose a short-term project that the market can more accurately evaluate and so assign it a higher valuation than a more opaque long-term project.[42] If management nonetheless chooses the long-term project, a hostile bidder can increase the market, but not the fundamental, value of the company by making a bid that shares the increase from a shift to a short-term strategy with the target shareholders through a premium bid, or seek the same outcome through an activist campaign.[43]

But the potential for managers to be myopic—to choose too short an investment horizon—is only half the problem. The other half is that management may be "hyperopic" when assessing the value of a current strategy—under-discounting future returns from continuing a strategy—with the result that stability is overvalued in comparison to change. GM's long-term underperformance, which we traced earlier, ultimately ending in bankruptcy, is an example of the problem.

And here is the fruit that is still out of reach without a ladder. How does a board distinguish between two cases presented in its capital budgeting process: when the market lacks management's private information and so myopic short-termism is a real risk; and when management is, in effect, holding an out of the money call option, and hyperopic stubbornness may be the problem? Admitting that their strategy is a failure will reduce the value of their human capital, but the value of their option goes up by extending their option's duration by sticking to the existing strategy even if doing so is a negative net present value investment: they may yet get lucky.[44]

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41. For example, Peter Drucker, perhaps the most prominent management scholar of this period, wrote in 1984 that "[A] good many experienced business leaders I know hold takeover fear to be a main cause of the decline in America's competitive strength in the world economy . . . [i]t contributes to the obsession with the short term." Peter F. Drucker, *Taming the Corporate Takeover*, WALL. ST. J. (Oct. 30, 1984), at 30. Michael Porter, a leading Harvard Business School strategy professor, provides a second example, blaming short-termism for the poor performance of the U.S. capital market compared to those of Germany and Japan. Michael Porter, *Capital Disadvantage: America's Failing Capital Investment System*, 70 HARV. BUS. REV. 65, 70–71 (1992).

42. I am sliding over problems with this characterization. Information asymmetry between management and the market that exists because credible direct disclosure cannot be made is an invitation for signaling. Some skepticism is warranted over the unstated assumption that an effective signal cannot be designed.

43. *See* Jeremy Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61, 62 (1988) (arguing that the threat of takeovers lead managers to focus on the short-term). The empirical evidence supporting a short-term bias is troublingly weak. Mark J. Roe, *Stock Market's Short-Termism's Impact*, 167 U. PA. L. REV. 71, 87–100 (2018).

44. Hyperopia can also be explained through psychological bias rather than finance-based incentives. *See, e.g.*, V. Bashtar & Caroline Thomas, *The Culture of Overconfidence*, 11 AER: INSIGHTS 95, 95 (2019)

The difference between governance systems becomes critical when there is a mismatch between a governance system that favors risk of hyperopia over that of myopia and the conditions in a company's industry. Hyperopia-favored governance privileges stability and long-term investment in firm-specific capital even at the risk of causing the company to be slow to adjust to new circumstances. Myopia-favored governance privileges the ability to quickly adjust in response to industry change, even at the risk of losing some long-term projects. As I wrote recently, "if the second derivative of change is positive but whose direction is difficult to predict, then a governance system that privileges mutability over stability will outperform."[45] And here is the high-hanging fruit. Can we design a governance system that wears bifocals—that is able to be both myopic and hyperopic simultaneously as circumstances in the market warrant? One can interpret the attraction to "agile" management[46] as an effort to be ambidextrous[47] or, as Reinier Kraakman and I have put it, to confront the tension between Burke and Schumpeter.[48]

("Perceptions of overconfidence can exacerbate the tendency of reputationally concerned leaders to continue bad projects.").

45. Ronald J. Gilson, *From Corporate Law to Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 3 (J. Gordon & W. Ringe eds. 2018).

46. *See, e.g.*, Darrell K. Rigby et al., *Embracing Agile*, HARV. BUS. REV. May 2016, https://hbr.org/2016/05/embracing-agile [https://perma.cc/88CM-LSX6] (describing how agile is really just innovation).

47. *See. e.g.*, Michael L. Tushman & Charles A. O'Reilly III, *Ambidextrous Organizations: Managing Evolutionary and Revolutionary Change*, 38 CAL. MGMT. REV. 8, 27–28 (1996) (describing agile management as "ambidextrous" management).

48. Ronald J. Gilson & Reinier Kraakman, *Takeovers in the Target Boardroom: Burke Versus Schumpeter*, 60 BUS. LAW. 1429, 1440–42 (2005).