

The “Corporate Contract” Today

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Abstract: This chapter examines the theoretical and empirical validity of the “contractarian” theory of corporate governance. Beginning with an overview of the contractarian theory and its conceptualization of the relationship between public company managers and shareholders, it explains how the theoretical assumptions of the contractarian theory have turned out to be invalid, and how the empirical predictions of the theory have not been borne out. The process by which “corporate contracts” develop do not fit the neoclassical model of atomistic competition. For this reason and others, the customization and innovation that the contractarian theory predicts do not occur—either at the IPO stage or at the “midstream” stage when companies are publicly traded.

Keywords: corporate governance, contractarian theory, IPO stage, midstream stage, managers, shareholders, public company, corporate law, corporate charters, corporate contract

1. Introduction

Led largely by the work of Frank Easterbrook and Daniel Fischel in the 1980s, a “contractarian” theory of corporate governance and corporate law dominated thinking among US corporate law scholars for many years.² The notion was that a public company’s shareholders and managers enter into a relationship with one another voluntarily on terms that are reflected in the company’s share price, and that managers, as agents in the relationship, have incentives to adopt governance arrangements that minimize agency costs and maximize firm value. The contractarian theory was a positive theory, positing that market forces would lead to optimal governance arrangements in

firms. It also had a clear normative implication, which was that there is little, if any, need for law to impose rules on the manager–shareholder relationship.³

Today, the status of the contractarian theory is unclear. Few would deny that when investors buy shares in a public company, they enter into a relationship with management that can reasonably be conceptualized as “contractual.” The key question, however, is whether the “corporate contract” is socially optimal, as the contractarian theory holds?⁴ Theoretical and empirical doubts have been raised over the years regarding the theory’s validity. We no longer hear the contractarian refrain in opposition to any and all corporate law reform proposals—that any particular proposal cannot possibly be value enhancing, because if it were, firms would have already adopted it in their charters, at least at the IPO stage. We do, however, hear a weaker variant of the contractarian claim, largely from advocates for management opposing legal rules that would shift power to shareholders. This modern-day variant of the contractarian theory is more of a slogan than a theory—that “one size does not fit all.”⁵

This chapter will evaluate the substantive validity of the contractarian theory in light of theoretical and empirical developments since the 1980s. As I explain in the remainder of this chapter, the contractarian theory was really two theories: one of the IPO stage, and one of the “midstream” stage, when a company is publicly held.

The theory of the IPO stage suffered from a few theoretical flaws, but most fundamentally it assumed that the relationship between shareholders and managers was captured by the neoclassical model of atomistic contracting, with no interdependencies across firms in the terms adopted. This was the basis of the theory that market equilibria must be socially optimal—and therefore the basis of the theory’s non-intervention

prescription.⁶ The IPO theory also depended on the validity of the midstream theory, since any arrangement put in place at the IPO stage could be undone at the midstream stage. With respect to empirical validity, contractarian theorists never attempted to investigate their claims empirically, and when some of us did later on, we discovered that the facts did not fit.⁷

The contractarian theory of the midstream stage was recognized from the start as weak. It relied on the existence of market forces to drive managers to adopt and maintain governance arrangements that promote shareholder interests. No proponent of the theory, however, convincingly explained how this would occur, and experience with management resistance of shareholder demands cast serious doubt on the theory as an empirical matter.

Beginning roughly in the mid-2000s, however, legal and nonlegal institutional changes have occurred in the US that one could characterize as a new contract between shareholders and managers. Today's contract is not an explicit contract written into a corporate charter, as the contractarian theory envisioned. It is instead an implicit contract in the sense that economists use that term—a contract that is not legally enforceable, but that is self-enforcing as a result of carrots and sticks that the parties hold. This new implicit contract reflects a shift in power from managers to shareholders compared to earlier decades. While one can make judgments regarding whether the current balance of power is better or worse than alternatives, there is no analytic basis on which to claim that the current equilibrium it is either optimal or suboptimal.

2. The Contractarian Theory

Built on the work of Jensen and Meckling and ultimately that of Ronald Coase, the original contractarian theory of the corporation characterized the relationship between managers and shareholders of a public company as one of contract mediated through the securities market. The implication of conceptualizing the shareholder–manager relationship as contractual was that, in the absence of transaction costs, externalities, or other market imperfections, market forces could be relied upon to create governance arrangements that minimize agency costs and thereby maximize firm value.

The theory was clearest and most promising at the point a company goes public. When a company goes public, its charter is in effect a contract between its management and its public shareholders. The charter confers legally binding rights on shareholders and obligations on managers. It can commit the company to separate the positions of CEO and board chair, to forgo a poison pill, to have a staggered board, to limit directors' exposure to liability risk, to require managers to hold a certain amount of stock, to compensate management in a certain way, and so on. There are few, if any, legal limits to this freedom.⁸ Pre-IPO managers and shareholders write the firm's post-IPO charter and sell shares to the public. As public investors purchase those shares, the market sets their price, and that price is expected to reflect the effectiveness of the firm's governance structure in reducing agency costs. Pre-IPO shareholders—venture capitalists, angel investors, managers, employees, and others—reap the benefit of a high share price and the detriment of a low share price. Hence, the contractarian theory posits, pre-IPO shareholders reap the benefit and detriment of good or bad governance structures.

Consequently, the contractarian theory posited that pre-IPO shareholders would design governance mechanisms that maximize the value of their firm, given the particular circumstances of each firm, and that pre-IPO shareholders would make legally enforceable commitments to those mechanisms by drafting them into their charters—the document that reflects the “corporate contract.”⁹ This is the simple, yet compelling, contractarian logic of how governance arrangements formed at the IPO stage.

Once shares of a company are dispersed among public shareholders, the concern became whether management could take advantage of its control to loosen the constraints adopted at the IPO stage or to decline to adopt new contractual constraints in response to agency cost-increasing changes in the business environment.¹⁰ Here, the contractarian theory held that market forces would induce management to maintain and update optimal governance arrangements, proposing charter amendments to shareholders where appropriate.¹¹ The claim was that managers would ultimately reap rewards—through higher compensation or longer-term career success—for increasing firm value by adopting good governance arrangements. This post-IPO or “midstream” element of the contractarian theory was viewed as its weakest, even by advocates of the theory.¹²

The contractarian theory’s normative claim followed from its positive claim that market forces would drive firms to adopt optimal, legally enforceable governance arrangements. If this were true, and there were no costs externalized on parties other than a firm’s managers and shareholders, then it would follow that corporate law should stay out of the way and impose no mandatory legal rules on the shareholder–manager relationship. Advocates of the theory viewed contractual governance as superior to legally imposed governance because firms vary along numerous dimensions, and market

forces were expected to induce firms to customize their own governance arrangements in ways that suited their particular circumstances. In addition, market pressure was expected to spur innovation in governance mechanisms over time. In the contractarian view, mandatory legal intervention would prevent customization, and state legislatures (let alone Congress) would be a weak source of innovation compared to the governance ingenuity present in individual firms.¹³

The proper role of corporate law in the original contractarian view was fairly minor. It was to provide default rules that firms could take “off the rack” and incorporate into their governance arrangements, and to enforce whatever terms firms adopted.¹⁴ Furthermore, in the United States, choice of corporate law is itself a matter of contract. When a firm goes public, its pre-IPO managers and shareholders select the state in which to incorporate, and in so doing, opt into that state’s body of corporate law. Once public, the firm can reincorporate with the approval of the firm’s board and its shareholders. Consequently, the contractarian expectation was that firms would initially incorporate, and later re-incorporate, in states whose corporate law best reduce agency costs in each particular firm.¹⁵

The conceptualization of the shareholder–manager relationship as “contractual” is relatively uncontroversial. Shareholders voluntarily enter into the relationship and in doing so they accept the terms of the deal. The securities markets price securities, so it is reasonable to expect that governance terms will be priced—though whether they are or not is an empirical question. But the fact that shareholders and managers come together voluntarily—even if we call the relationship “contractual”—does not mean that the terms of the contract will be socially optimal, as the contractarian theory maintains. There could

be a market imperfection that breaks the neoclassical connection between market equilibrium and social optimality.

If the original contractarian theory had been valid, we would expect to see the following:

- firms, at least at the IPO stage, adopting diverse and innovative governance arrangements in their charters;
- governance arrangements tending to maximize firm value; and
- once firms are publicly held, managers proposing value-increasing charter amendments for shareholder approval.

As discussed in the remainder of this chapter, we observe none of the above. In [section 3](#), I explain how the contractarian theory's claim about the IPO stage are invalid, and in [section 4](#), I address its invalidity with respect to the midstream stage—once companies are publicly held. Finally, in [section 5](#), I discuss what appears to be a newly emergent unwritten implicit contract that reflects a shift in power from managers to shareholders.

3. The Contractarian Theory of the IPO Stage Does Not Hold Up to the Facts

In the discussion below, I first report the results of empirical studies of two questions. First, do firms customize and innovate governance-related charter terms when they go public? Second, do IPO charters appear to maximize firm value? The contractarian theory of the IPO implies a positive answer to both questions. The data, however, answer the questions primarily in the negative. After discussing these empirical findings, I explain how the contractarians went wrong as a theoretical matter.

3.1 Customization and Innovation, or Plain Vanilla IPO Charters?

The contractarian theory implied that firms would customize and innovate governance arrangements that minimize agency costs to suit their particular business environments, and that firms would make legally binding commitments to those arrangements in their charters. Describing the “corporate contract,” a term they coined, Easterbrook and Fischel stated: “Agreements that have arisen are wonderfully diverse, matching the diversity of economic activity carried on within corporations.”¹⁶ But is this true? Do corporate charters contain customized and innovative governance terms?

In a study published in 2013, I investigated this question by collecting data from a random sample of 373 companies that went public during the period from 2000 through 2012.¹⁷ I searched their charters (and bylaws) for examples of governance customization and innovation.¹⁸ I searched for any nonstandard governance mechanism. In order to structure the search, however, I specifically looked for arrangements that have been the focus of corporate governance debates since the 1980s. Some of these governance arrangements became mandatory under the Sarbanes–Oxley Act or the Dodd–Frank Act: majority independent board, independent board committees, and say on pay. One mechanism, proxy access, was briefly mandated by the SEC and is now explicitly permitted but not mandated. A fifth innovation, majority voting in shareholder elections of directors, has been widely adopted by publicly held firms, and has been shown in some studies to be value enhancing. For each governance innovation that ultimately became legally required, I investigated whether the innovation had previously appeared in IPO charters (or bylaws).¹⁹ For purposes of this chapter, I supplemented these data on these governance innovations with data on a sixth innovation—exclusive forum provisions for

shareholder litigation. I obtained these data from Roberta Romano and Sarath Sanga, who have studied the diffusion of these provisions in IPO charters. Exclusive forum provisions require that all corporate-law-related disputes be brought in a single forum—typically the forum of the state in which the company is incorporated, which for companies adopting these provisions is nearly always Delaware. I obtained these data from Roberta Romano and Sarath Sanga, who have found that these provisions appear in IPO charters beginning in 2010, when they were endorsed in an opinion of the Delaware Chancery court.²⁰

A finding that these six innovations commonly appear in IPO charters would support the contractarian theory that the economics of the IPO stage promotes governance innovation and customization. Conversely, a finding that they never or rarely appear in IPO charters would cast substantial doubt on the theory. Although it is possible that the particular innovations for which I searched are not value enhancing for *any* firm, this would be a far-fetched interpretation.²¹

Table 1 presents my findings. Of the innovations described above, only exclusive forum provisions were adopted to any significant extent. Of 373 firms sampled, no firm had any of the five other provisions in their charters, and only nine firms had bylaws containing one or more of the five arrangements. Because management could amend these bylaws unilaterally, this handful of provisions are not contractual in the contractarians' sense of the term.²²

Table 1

Incidence of governance innovations or customization in IPO bylaws (2000–2012)

	Relevant Period	Yes	No	Total
Majority Independent Board	1/1/2000 to 4/1/2004*	0	127	128
Independent Compensation Committee	1/1/2000 to 4/1/2004*	1	127	128
Independent Nominating Committee	1/1/2000 to 4/1/2004*	0	128	128
Independent Governance Committee	1/1/2000 to 4/1/2004*	0	128	128
Proxy Access	1/1/2000 to 12/31/2012	0	224	373
Majority Vote	1/1/2000 to 12/31/2012	4	220	373
Say on Pay	1/1/2000 to 1/21/2011**	0	143	314
Separation of CEO and Board Chair	1/1/2000 to 12/31/2012	4	369	373
Exclusive Forum	1/1/2000 to 12/31/2012	30***	373	373

* These periods end when the independence requirements of the Sarbanes–Oxley Act became effective.

** This period ends when the SEC adopted its mandatory say-on-pay rule. Differences in totals reflect shorter and longer time periods relevant for each mechanism.

*** All 30 of these IPOs occurred after the Delaware Chancery Court decision endorsing these provisions.

Where do these data leave us regarding the contractarian claim that IPO charters are a locus of innovation and customization in corporate governance? The claim is largely inconsistent with the data. The experience with exclusive forum provisions is unique and, at best, can be generalized only to charter terms that are directly beneficial to management—presumably along with shareholders. Unlike the other provisions that potentially enhance firm value by enhancing shareholder rights, exclusive forum provisions potentially do so by protecting directors and officers from burdensome litigation in multiple jurisdictions. Whether or not they enhance share value, they are attractive to management and could well be adopted for that reason alone. Protecting directors and officers from litigation risk is in the wheelhouse of the lawyers advising management of firms going public. A lawyer would readily understand the provision and

how it could benefit management and perhaps increase firm value. This is not necessarily true of innovations that increase firm value by enhancing shareholder rights.

Insert Table 1 here

The lack of governance diversity evident in charters is also evident in firms' incorporation choices. A large and increasing majority of firms incorporate in Delaware, and nearly all others incorporate in their home states for reasons apparently unrelated to value-maximizing choices of corporate.²³

The most plausible explanation for these findings is that the contractarian claims about the IPO stage are incorrect or at least drastically overstated. But how could the theory be incorrect when it is undeniable that shareholders enter into a relationship with managers voluntarily, and that they do so in a setting that can be reasonably described as contractual? I address that question in [section 3.3](#).

3.2 Are IPO Charters Suboptimal?

The near absence of customization and innovation in IPO charters poses a serious challenge to the contractarian claim that the economics of the IPO stage promotes value-maximizing contracting. Additional evidence weighing against this claim is the presence of staggered boards in the charters of many firms going public. Although some recent studies have found that staggered boards are associated with higher firm value in certain situations,²⁴ the bulk of the research finds that staggered boards are value-reducing mechanisms that management uses to protect itself from the market for corporate control.²⁵ This was certainly the prevailing view when the contractarian theory was developed. The contractarian theory, therefore, implied that staggered boards would not appear in IPO charters. Easterbrook and Fischel expressed this expectation as a statement

of fact: “[Takeover defenses] are not included [in IPO charters]. Instead firms go public in easy-to-acquire form: no poison pill securities, no supermajority rules or staggered boards. Defensive measures are added later, a sequence that reveals much.”²⁶

Whether IPO charters contain takeover defenses was an empirical question that was not investigated for another decade. Easterbrook and Fischel apparently made the factual statement above based on theory alone, and for the next decade no one thought it was worth reading actual charters to validate the theory empirically or even anecdotally.

Three articles published in 2001 and 2002 presented data on the charters of firms going public. Each found that IPO charters commonly contain takeover defenses, including staggered boards.²⁷ The studies covered different sample periods between 1988 and 1999 and found that between 34% and 82% of sample firms had staggered boards, with higher frequencies in later years.

Two of these articles analyzed whether there were efficiency explanations for the presence of staggered boards in IPO charters. Both Laura Field and Jonathan Karpoff and Robert Daines and I analyzed whether the adoption of staggered boards was explained by the need for extra bargaining power in the event of a hostile bid.²⁸ Neither study found support for this explanation. Daines and I also tested whether staggered boards were explained by asymmetric information regarding firm value, which would create the possibility of undervaluation by the market and hence a vulnerability to bids lower than true value. We found no support for this explanation either. In fact, Daines and I found that staggered boards tended to be present when both these efficiency theories suggested that they would be *least* needed. We concluded that, contrary to the contractarian theory, management entrenchment was the best explanation for staggered boards in IPOs.²⁹

John Coates investigated the influence of lawyers in the adoption of staggered boards. He found that firms that were advised in their IPOs by law firms with extensive M&A transactional or litigation work tended to adopt staggered boards more frequently than did other firms. He inferred that those law firms instill in their lawyers, or in the form charters that their lawyers use, a preference for takeover defenses. As Coates explains, this is hardly evidence of value maximization at work.

There is, however, some recent research supporting the proposition that staggered boards can enhance firm value for a subset of firms under limited circumstances.³⁰ I therefore cannot rule out the possibility that some day we will have a satisfactory efficiency-based explanation for staggered boards in IPO charters. At this point, however, their presence certainly appears to further undermine the contractarian theory of the IPO stage.

3.3 Where Did the Contractarian Theory Go Wrong Regarding the IPO Stage?

The contractarian theory's application to the IPO stage was its most convincing. Neoclassical theory, coupled with the undeniable fact that shareholders and managers enter into their relationship voluntarily, seemed unequivocally to imply that market forces would produce socially optimal governance arrangements. Yet the facts do not fit the theory. With the exception of exclusive forum provisions, there has been no governance innovation or customization at the IPO stage, and the common use of staggered boards raises serious doubts about the theory's optimality claims, independent of the lack of customization or innovation. What was the flaw in the logic? Theoretical developments

and some further thought have yielded at least two theoretical explanations for the failure of the IPO stage to conform to contractarian expectations. This section provides those explanations.

3.3.1 Customization and Innovation

Two explanations have emerged to explain why the IPO stage does not generate customized or innovative governance arrangements. The first explanation is well grounded in economic theory, but not the neoclassical model on which the contractarian theory was based. Consistent with neoclassical economics, the contractarian theory assumed that each firm's decision to adopt a particular governance arrangement is independent of other firms' decisions—that firms were atomistic actors in that one firm's choice of a governance structure has no effect on another firm's choice. For at least some corporate governance arrangements, however, this assumption is not valid. There are interdependencies among firms' choices of governance arrangements. The value of a governance mechanism can be dependent on the number of firms that use the mechanism. If few firms use a governance mechanism, the mechanism will not be as valuable as if many firms use it. The underlying dynamic is the same dynamic that is present in product markets with network externalities, such as the market for computer operating systems, word processing and spreadsheet applications, and social network platforms such as Facebook. In each of these markets, the value of a product increases with the volume of use. (Imagine Facebook with one user or even 1,000.)

When network benefits are present, market forces will not necessarily yield socially optimal equilibria. In this type of market, theory shows that there are multiple,

socially suboptimal equilibria. In one suboptimal equilibrium, excess uniformity emerges in the products produced. Note that there are very few computer operating systems, word processing and spreadsheet applications, and social network platforms and that each has a large number of users—in contrast, say, to the markets for office supplies, skis, and restaurants. This appears to be the case with respect to corporate governance—there is little variety in the corporate governance arrangements; firms’ governance arrangements are fairly uniform.³¹

Corporate governance arrangements have some of the same qualities as network products. The more firms there are that use a governance mechanism or that operate under the same legal or contractual rule, the more valuable the arrangement becomes. One source of these network benefits stems from judicial precedents that interpret the arrangement in varied settings, thereby reducing legal uncertainty. One can think of each new judicial opinion in a new setting as analogous to a software update for Windows or Word. The more firms there are that operate under, say, a particular state’s fiduciary duty standard, the more precedents there will be—today and into the future. Firms will therefore be attracted to incorporate in that state, and to adopt its default fiduciary duty rule.

Judicial precedents are especially valuable when a governance arrangement entails a legal or contractual rule that is framed as an open-ended legal standard, as opposed to a detailed, specific rule. Open-ended standards are pervasive in corporate law and governance. Fiduciary duties are classic, open-ended legal standards, as are concepts of director disinterestedness and materiality in the disclosure context. They are given content as courts interpret them in a variety of contexts. A firm that adopts, for example,

its own unique fiduciary duty, definition of director disinterestedness, or disclosure rule would not have the benefit of ongoing judicial interpretations. The customized arrangement would remain static, unless it is amended (which entails a separate set of problems discussed below). In contrast, a commonly used arrangement will evolve with judicial interpretations. As a result, a firm with a customized arrangement will face greater uncertainty regarding how its own arrangement will apply in unanticipated settings.

Other network benefits associated with corporate governance arrangements are familiarity among lawyers advising firms and familiarity among investors. A lawyer who is familiar with a legal rule can provide advice based on his or her experience, independently of legal precedents. That advice will be more valuable in reducing legal uncertainty than advice regarding a governance arrangement the lawyer has never seen before. Similarly, all other factors being equal, familiarity among investors will be a benefit for a firm. Investors considering the securities of a firm with a unique governance arrangement will have to figure out what the arrangement means in terms of value to the investor. All other factors being equal, this will deter investment and could drive down the liquidity and value of a company's securities.

Network benefits associated with corporate governance arrangements tend to make default rules attractive. It is not that default rules are inherently more attractive from the start than alternatives, but rather that they typically are expected to be widely adopted in the future. This may be due to a focal quality that default rules have or to the state legislature's endorsement. Governance rules and structures provided by statute as menu options—such as staggered boards, voting by written consent, shareholders calling

a special meeting, exculpatory charter provisions, and more—have a similar quality. Once statutory terms, whether default or menu, have been used and litigated, their attraction to new firms is even greater.

Delaware corporate law, specifically its default rules and statutory menu options, has benefited from network effects. The large installed base of firms incorporated in Delaware ensures a constant supply of judicial decisions applying Delaware law to many situations. There also is a large supply of lawyers with expertise in Delaware law and an investment community familiar with the workings of key governance arrangements.³² The expertise of Delaware judges is certainly a major attraction as well, but that too is a result of the large number of firms incorporated in Delaware, which produce a large volume of corporate litigation. This volume of litigation has both made the job of the Delaware judge attractive to talented Delaware corporate lawyers and enhanced their expertise while in the job.

Network benefits do not necessarily preclude customization, innovation, or incorporation in a state other than Delaware. If the inherent value of an innovative or customized governance arrangement outweighs the network benefit of a widely used arrangement, a firm could well adopt the former. This would tend to occur with respect to governance arrangements that do not entail open-ended standards, like Delaware fiduciary duties, or a high degree of complexity, like that of disclosure rules under the securities laws. An example of a governance term the attraction of which is not significantly affected by network benefits might be a charter provision that separates the CEO and board chair. This is clear and simple, with no great need for interpretation by courts or expertise in application by lawyers. The network quality of many corporate

governance arrangements, however, creates a bias—and apparently a very large bias—in favor of conformity along many dimensions of corporate governance.³³

Accordingly, the theory of network externalities tells us that while a firm going public may maximize its own value by adopting Delaware default rules, all other factors being equal, this does not mean that it is socially optimal for large numbers of firms to adopt Delaware default rules. Accordingly, from a societal point of view, there could well be a suboptimal level of innovation and customization. Moreover, any given default rule may be inherently suboptimal in the sense that an alternative rule might increase aggregate firm value across all firms *if* it were widely adopted. Similarly, greater heterogeneity in incorporation choices could be socially beneficial. Thus, network externalities inherent in corporate governance arrangements may explain why there is so much uniformity in corporate governance and further explain that, contrary to the contractarian theory, there is no reason to believe this market outcome is socially optimal.

A second explanation for the lack of governance customization or innovation at the IPO stage lies in the acknowledged weakness of the contractarian theory of the midstream stage. The dependence of the IPO leg of the theory on the weaker “midstream” leg was overlooked by the original contractarians, but there is an important link. Optimal governance arrangements for a firm can change over time. Moreover, as a firm lives with a particular governance arrangement for a period of time, problems may become apparent. If the pre-IPO shareholders and investors can be sure that a suboptimal arrangement will be modified later on, perhaps they would be more inventive at the IPO stage. But if such a change would impair management’s discretion or reduce its perks, there can be no assurance that management will agree to modify the arrangement when it

becomes optimal to do so. That is, shareholders cannot count on a midcourse correction. Consequently, an innovative or customized arrangement adopted at the IPO stage could last as long as the firm exists, which could well make it inherently unattractive at the IPO stage.

3.3.2 Staggered Boards at the IPO Stage

Network benefits do not explain why firms adopt staggered boards at the time they go public. Both annually elected and staggered boards are well defined by statute, commonly used, and addressed by a large body of case law ruling on board conduct with each type of board. No-one has come up with a satisfying explanation for the widespread, but not universal, adoption of staggered boards among companies going public, but there are a few candidates.

First, while the bulk of the research suggests that staggered boards tend to reduce firm value, it may be that staggered boards increase shareholder value for some firms. Second, while staggered boards may reduce share value, they could provide more than offsetting private benefits to managers, in which case they could increase the total value of a firm. Perhaps the managers of firms that go public with staggered boards enjoy especially high private benefits and perhaps the cost to shareholders is low.³⁴ Daines and I tested this hypothesis and found no support, but private benefits are not directly observable and proxies for their presence are imperfect. Therefore, we could not exclude this explanation of the data. Either of these explanations, if borne out, would eliminate the inconsistency between the contractarian theory and the common use of staggered boards.

A third potential explanation that would pose a moderate threat to the contractarian theory is that, even if pre-IPO managers and shareholders incur costs by having their firms go public with staggered boards, they can recoup those costs later by having their boards de-stagger before they selling their shares. So long as pre-IPO shareholders can coordinate with one another and control the firm's board before any wants to sell, a staggered board provides an implicit option on an annually elected board in the future. Public shareholders will gladly vote to de-stagger a board if the incumbent board gives them the opportunity. On the other hand, an annually elected board is permanent. Public shareholders cannot be expected to adopt a staggered board later on. Thus while this interpretation of staggered boards at the IPO stage is plausible in the abstract, it has no empirical support. Until recent years, firms did not de-stagger their boards after going public, and many firms' pre-IPO shareholders sold shares not long after their IPO. Moreover, even in recent years, the de-staggering that has occurred has been in response to public shareholder demands, not the interest of insiders who want to sell their shares.

A fourth explanation that does call into question the contractarian theory—indeed one that amounts to heresy among economics-oriented scholars—is that governance arrangements adopted at the IPO stage may not be priced. John Coates raised this possibility in his study of staggered boards at the IPO stage, stating: “A lack of pricing penalty is also consistent with anecdotal reports from IPO participants, including investment bankers, venture capitalists, and lawyers from Wilson Sonsini (among other lawyers), who all uniformly report in conversations that conventional defenses do not affect IPO pricing.”³⁵ A difficulty with this explanation is that since most pre-IPO

shareholders, including venture capitalists, continue to own shares after the IPO, the pricing explanation for the presence of takeover defenses would have to extend to pricing in secondary market trading after the IPO as well. This is more difficult to believe, especially in light of studies showing that staggered boards have an impact on price.³⁶

In sum, the weight of the evidence suggests that the widespread adoption of staggered boards at the IPO stage is inconsistent with the contractarian theory. But we still lack a satisfying explanation for why a large number of firms would adopt an apparently suboptimal governance arrangement when they go public.

4. The Contractarian Theory of the Midstream Stage also Misses the Mark

In the foreword to a widely read issue of the *Columbia Law Review* in 1989, Lucian Bebchuk stated: “The debate on contractual freedom in corporate law should be viewed as two debates, not one. The questions of contractual freedom in the initial charter and in midstream (that is, after the corporation is publicly held) are different and require separate examination.”³⁷ In the same issue, Easterbrook and Fischel acknowledged that “[t]he difference between governance provisions established at the beginning and provisions added later suggests some caution in treating the two categories alike.”³⁸

Once a company goes public, the conceptualization of the manager–shareholder relationship as “contractual” is less accurate than at the IPO stage. The board can make substantial changes to a company’s governance structure unilaterally—for example, it can adopt a poison pill or change executive compensation. It can also decline to accede to a value-enhancing charter amendment that disfavors management.

Contractarians nonetheless had faith that market forces would yield optimal governance arrangements once a company is publicly held. They supported their position in two ways. First, they expected that IPO charters would contain provisions that constrain management from changing corporate governance arrangements to the disadvantage of shareholders—limits on management’s freedom to adopt a poison pill, for example.³⁹ Second, they believed that market forces would pressure boards to initiate value-increasing governance arrangements. Their logic was that poor governance structures would lead to high costs of capital, which in turn would lead to a lack of competitiveness in the product market, which ultimately would lead to a takeover or bankruptcy and the loss of managers’ jobs.⁴⁰ There was a division in the ranks of the contractarians with respect to midstream adoption of governance arrangements related to takeover defenses—for example, a charter provision that disallowed the adoption of poison pills. Easterbrook and Fischel believed that boards should pre-commit to remain passive in response to a takeover bid and allow shareholders to tender their shares. They were doubtful, however, that boards would actually initiate charter amendments imposing such a restriction on themselves, and were thus inclined toward a mandatory legal rule requiring passivity.⁴¹ This sole instance of a lack of faith in their own contractarian logic in such an important area of corporate governance was surprising. David Haddock, Jonathan Macey, and Fred McChesney cried foul. Market forces, they believed, would indeed induce management to adopt value-maximizing charter amendments, including arrangements that limited management’s defense against hostile bids. Although Haddock et al did not explain what market mechanisms would provide such discipline, and they did not provide any examples of managers whom the market punished for failing to

promote shareholder interests in this way, they nonetheless expressed this faith based on “overwhelming [though uncited] empirical evidence from various aspects of corporate governance suggest[ing] that faithful managers are rewarded while the faithless are punished.”⁴²

The contractarian claims for the midstream stage raise two empirical questions: First, do IPO charters constrain management-initiated midstream governance changes, as the contractarians expected? Second, after a company goes public, do managers tend to initiate value-enhancing charter amendments to improve governance—regarding takeover defenses or otherwise?

Empirical studies of IPO charters address the first question unequivocally: IPO charters do not constrain management’s initiation of midstream governance changes.⁴³ Indeed, in contrast to the contractarian expectation, IPO charters commonly restrict *shareholders* from initiating governance changes by requiring supermajority shareholder votes to amend bylaws—particularly bylaw provisions that protect management.⁴⁴

Regarding the second question—whether management initiates value-enhancing charter amendments—there is no evidence of such a contractarian invisible hand driving management to initiate such charter amendments. On the contrary, until recent years, when shareholders have exerted pressure on management to improve governance, management resisted. From the late 1980s to the mid-2000s, shareholders and managers battled over takeover defenses.⁴⁵ Shareholder proposals to redeem poison pills or to subject them to shareholder approval received substantial and increasing support throughout this period, as did shareholder proposals to destagger boards.⁴⁶ Nonetheless, management declined to accede to either demand.⁴⁷

In sum, the experience of the period from the mid-1980s to the mid-2000s does not support the contractarian expectation that management would initiate agency cost-reducing charter amendments.

5. Corporate Governance since the Mid-2000s: A New (Implicit) Corporate Contract?

In the wake of the Enron and WorldCom scandals of the early 2000s and the passage of the Sarbanes–Oxley Act in 2002,⁴⁸ dramatic changes occurred in the US that shifted power from management to shareholders. Some of these were changes in the law. Others were nonlegal institutional changes. Still others were norms that directors appear to have adopted.

These changes have created a new *implicit* contract in the economists' sense of that term—a self-enforcing arrangement in which parties have carrots and sticks that keep their interests aligned. The central weakness of the contractarian theory of the midstream stage was that the market mechanisms envisioned as aligning shareholder and management interests were largely just that—envisioned, with little if any theoretical or empirical support. The ultimate connection between weak governance structures and market forces leading to managers being fired was conceivable, but the connection needed to be proved. It wasn't. Beginning in the mid-2000s, however, new mechanisms emerged that have induced managers of public companies to act in the interest of shareholders. The new implicit contract thus turns the contractarian theory on its head. It works at the midstream stage while the IPO stage remains largely moribund from a contracting perspective.

There is no basis for claiming that the new implicit contract is optimal. To the extent that agency costs were a significant concern in the past, the shift in power toward shareholders could well be a change for the good. On the other hand, critics of the new regime correctly point out that the newly powerful institutional shareholders are run by agents, and that the proxy advisers on which they rely may well offer ungrounded judgments.⁴⁹

5.1 Legal Changes

The Sarbanes–Oxley Act and the stock exchange rules issued in the aftermath of the Enron and WorldCom scandals imposed several requirements on firms regarding the independence and role of outside directors. A majority of directors must satisfy the stock exchanges’ criteria for independence.⁵⁰ Independent directors must meet at least once a year in executive session without members of management present, and they must name a director to lead those meetings.⁵¹ In many companies, the result has been the establishment of an ongoing position of lead director.⁵² In addition, Sarbanes–Oxley expanded the role of the audit committee and strengthened its independence requirements.⁵³ The New York Stock Exchange required that boards create compensation, nominating, and governance committees, each comprised entirely of independent directors.⁵⁴ The NASDAQ did not require firms to form those committees, but it required that CEO pay and other executives’ pay be approved by either a majority of independent directors or a compensation committee comprised of independent directors. The NASDAQ imposed a similar requirement for the nomination of directors.⁵⁵ These requirements imposed formal independence on boards. But how independently

directors would actually conduct themselves remained to be seen, and of course would necessarily vary across firms.

5.2 Nonlegal Changes

Heading into the mid-2000s, non-legal changes were also developing in the US governance environment. These changes involved executive pay, the composition and attitude of shareholders, and the ability of shareholders to overcome the collective action problem that shareholders had faced in the past. In combination with the legal changes that had occurred, the result appears to be a greater alignment of management interests with shareholder interests.⁵⁶

From the 1980s to the 2000s, executive pay became increasingly stock-based. John Core and Wayne Guay found that, between 2004 and 2008, the median holdings of company stock by CEOs ranged from \$59 to \$79 million (accounting for stock options by converting them into stock equivalents).⁵⁷ This was ten times the amount of stock CEOs held in 1993. CEOs' increased share ownership is the carrot that is expected to lead them to act in the interests of shareholders.

Institutional shareholdings also increased dramatically from the 1990s to the 2000s. Total institutional stock ownership increased from 37% in 1990 to 50% in 2008.⁵⁸ This increased concentration of shareholdings created an inchoate stick in the new implicit corporate contract. In order for shareholders to wield that stick effectively, however, additional forces would be helpful.

One development that enhanced the power of institutional shareholders was the advent of the proxy advisory services—Institutional Shareholder Services (ISS) and

Glass Lewis. ISS and Glass Lewis emerged well before the 2000s, but their power grew as institutional shareholdings grew. These organizations communicate information and substantive judgments to institutional shareholders and, in effect, coordinate voting on everything from board elections to merger approvals to approvals of stock option plans. A second development in the mid-2000s was the emergence of the activist hedge fund. Although the shareholdings of hedge fund activists are relatively small, traditional institutions have supported their challenges of management.⁵⁹ As a result of these developments, the collective action problem long associated with shareholder voting is not an impediment to shareholders exerting power over management. Institutions are able to use the stick that their increased shareholdings gave them.

The stick was arguably enhanced further in the mid-2000s by firms' adoption of majority voting in place of plurality voting. Under majority voting, a director running unopposed needs to garner a majority of votes in order to keep his or her board seat.⁶⁰ From the beginning of 2006 through 2007, the percentage of S&P 500 firms that adopted majority voting rose from 16% to 66%,⁶¹ and from 2003 to 2009, the number of S&P 100 firms that adopted majority voting rose from ten to 90.⁶² This rapid adoption of majority voting both reflected the growing power of shareholders and potentially increased their power. Although few directors have lost their seats by failing to receive a majority of votes,⁶³ majority voting and "just vote no" campaigns seem to augment the power of the shareholders' stick. A recent study found that majority voting increases firms' responsiveness to shareholder concerns, and that the adoption of majority voting was associated with an increase in share price.⁶⁴

At least as dramatic as the rapid spread of majority voting was the de-staggering of boards in the mid-2000s—after two decades in which boards refused shareholder demands to de-stagger. According to one study of the period from 2003 to 2010, approximately 60 firms per year de-staggered their boards—compared to an average of four firms per year from 1987 and 2002.⁶⁵ Like majority voting, the de-staggering of a board both reflects increased shareholder power and further adds to their power. Not only does a de-staggered board mean a lower barrier to a takeover, it also exposes all directors every year to the danger of becoming the target of a “just vote no” campaign, especially in combination with majority voting.

Marcel Kahan and Edward Rock, who have reported on these changes in a series of articles,⁶⁶ conclude that the consequence of these legal and institutional developments has been a change in directors’ conception of their role: independent directors became not just nominally independent but “substantively” independent.⁶⁷ As Kahan and Rock explain, this substantive independence is evident in surveys regarding how much time directors devote to their board responsibilities, how directors spend their time, and how they view their roles.⁶⁸

In sum, by roughly the mid-2000s a system of carrots and sticks arose that created what economists would call an implicit contract between management and shareholders. Greater stock-based pay and stock holdings shifted CEOs’ interests more toward shareholder interests, and the potential for collective action among institutional shareholders has kept CEOs’ feet to the fire in terms of satisfying shareholder demands.

Is this the contract the contractarians originally had in mind? No. First, it took two decades to come together, and even then only after key legal changes occurred.

Moreover, it happened at the midstream stage, which was the weakest leg of the contractarian theory. The IPO stage, which was the core of the contractarian claims and which relied on legally enforceable commitments, remains largely moribund as a source of innovation or customization.

Moreover, as legal and nonlegal institutional changes in the 2000s have increased shareholder power, there has been a mild resurgence of contractarian-like rhetoric *against* the changes. This opposition has come from advocates for management, most visibly Wachtell Lipton Rosen & Katz and the Business Roundtable, and from some academics, with Professor Stephen Bainbridge providing the most sweeping criticism of these changes. The battle cry of these opponents is “one size does not fit all.” They leveled this rhetorical weapon at Sarbanes–Oxley’s requirements concerning independent directors, Dodd–Frank’s requirements regarding executive compensation, the SEC’s proxy access proposal, and ISS’s approach to some governance issues.⁶⁹

With respect to proxy access, the Business Roundtable and Wachtell Lipton took the position that the proposed mandatory rules should instead be default rules, and that *shareholders* should be permitted to vote to have their corporations opt out of them. This is quite different from the approach of the original contractarians, who believed that *management* would have incentives to do right by the shareholders. Bainbridge, however, has maintained the original contractarian line, advocating “board centric” corporate governance.⁷⁰

6. Conclusion

This chapter has addressed two questions. The primary question is whether the contractarian theory is a valid positive theory of corporate governance. The answer to that question is no. The theory does not fit the facts uncovered in empirical studies of the content of corporate charters at the IPO stage—the primary focus of the contractarian theory. Corporate charters at the IPO stage are not the fount of innovation and customization that the contractarian theorists imagined them to be, and there is no reason to believe that pre-IPO shareholders customize their charters to maximize firm value. With the exception of the *sui generis* case of exclusive forum provisions, essentially no innovation or customization occurs in charters. On the contrary, charters are boilerplate documents that overwhelmingly adopt default rules or statutory menu options. Furthermore, the primary menu option that has been adopted is the staggered board, which the weight of evidence suggests reduces firm value. The essentially uniform adoption of default rules and menu options—primarily those of Delaware—is instead consistent with the theory that network economics drive the adoption of corporate governance arrangements. The implication of this alternative theory is that legal rules are important to maintaining effective corporate governance. In contrast to the claims of the contractarian view, decentralized contracting between management and shareholders will not get us there.

The contractarian theory was always viewed as weak with respect to the midstream stage. Are managers of public companies truly subject to strong incentives to adopt governance structures that enhance firm value? The contractarians of the 1980s and 1990s did not make a convincing case that they were, and the midstream theory was not

supportable. But by the mid-2000s, legal and institutional changes had led management to respond to shareholder interests as never before. Firms have de-staggered their boards, adopted majority voting, faced withhold-the-vote campaigns, responded to activist demands, and increased stock-based pay for management so that management's financial interests have shifted toward shareholder interests. This is not the result of any sort of charter-based, legally enforceable contract that the contractarians imagined. Nor is it the result of managers simply responding to market forces as the contractarians envisioned. It is instead the result of legal and nonlegal changes that occurred over twenty years. These institutional changes have created a new implicit contract in the economists' sense of that term—a self-enforcing set of legal and nonlegal carrots and sticks that has emerged to shift managements' interests toward (but not necessarily into perfect alignment with) shareholders' interests. Of course, one does not have to use the term “contract” to describe the system of carrots and sticks that shapes corporate governance. I use that term here simply to draw at least a linguistic connection with the original theory of market-driven corporate governance. One could instead describe the relationship simply as one in which legal rules and market forces have engendered a set of institutions and norms that constrain management to be responsive to shareholder interests to an extent that may or may not enhance firm value.

¹ I would like to thank Michal Barzuza, Marcel Kahan, Jeff Gordon, and Georg Ringe for helpful comments on earlier drafts on this chapter.

² [Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law*](#)

[15 \(1991\)](#). The contractarian theory originated in the context of US corporate law and was developed and debated primarily by US scholars. Corporate law scholars

outside the US, in the past and to some extent today, tend of begin with a more regulatory perspective. This chapter, therefore, focuses on the US context and on the contractarian debate in the US. The following are some of the early articles that contributed to the contractarian theory: [Oliver E. Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting \(1985\)](#); [Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 Am. Econ. Rev. 777 \(1972\)](#); [Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, 26 J.L. & Econ. 301 \(1983\)](#); [Sanford J. Grossman & Oliver D. Hart, The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration, 94 J. Pol. Econ. 691 \(1986\)](#); [Henry Hansmann, Ownership of the Firm, 4 J.L. Econ. & Org. 267 \(1988\)](#); and [Benjamin Klein et al., Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 J.L. & Econ. 297 \(1978\)](#); [Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 \(1976\)](#); [Ronald Coase, The Nature of the Firm, 4 Economica 386 \(1937\)](#). The following are some articles that applied and further developed the theory: [Barry Baysinger & Henry Butler, Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law, 10 J. Corp. L. 431, 457 \(1985\)](#) (hereinafter, Race); [Barry D. Baysinger & Henry N. Butler, The Role of Corporate Law in the Theory of the Firm, 28 J.L. & Econ. 179, 182–183 \(1985\)](#) (hereinafter Role of Corporate Law); [Barry D.](#)

[Baysinger & Henry N. Butler, Antitakeover Amendments, Managerial](#)

[Entrenchment, and the Contractual Theory of the Corporation, 71 Va. L. Rev.](#)

[1257 \(1985\)](#) (hereinafter, Antitakeover Amendments); [Jonathan Macey, David D.](#)

[Haddock & Fred S. McChesney, Property Rights in Assets and Resistance to](#)

[Tender Offers, 73 Va. L. Rev. 701 \(1987\); Jonathan Macey, Corporate Law and](#)

[Corporate Governance: A Contractual Perspective, 18 J. Corp. L. 185 \(1993\).](#)

³ Easterbrook & Fischel, *supra* note 2, at 15. Although I will refer to corporate law throughout this chapter, the points that I make apply broadly to corporate law, securities law, and listing requirements—any rules that govern the shareholder–manager relationship.

⁴ Id. 7.

⁵ See, e.g., Letter from [Cravath, Swaine, & Moore LLP et al. to Elizabeth Murphy, Secretary, US Securities and Exchange Commission](#) (Aug. 17, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-212.pdf> (hereinafter Seven Firm Letter); Letter from Wachtell, Lipton, Rosen, & Katz to [Elizabeth M. Murphy, Secretary, US Securities and Exchange Commission](#) (Aug. 17, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-263.pdf>; letter from Business Roundtable to [Elizabeth Murphy, Sec’y, US Securities and Exchange Commission](#), available at <http://businessroundtable.org/resources/business-roundtable-statement-on-the-presidents-remarks-on-financial-regula>.

⁶ Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 Va. L. Rev. 757, 826–829 (1995).

⁷ Michael Klausner, Fact and Fiction in Corporate Law and Governance, 65 Stan. L. Rev. 1325 (2013); Robert Daines & Michael Klausner, Do IPO Charters Maximize Firm Value? Antitakeover Provisions in IPOs, 17 J.L. Econ. & Org. 83, 87 (2001); John C. Coates IV, Explaining Variation in Takeover Defenses: Blame the Lawyers, 89 Calif. L. Rev. 1301, (2001) Laura Casares Field & Jonathan M. Karpoff, Takeover Defenses of IPO Firms, 57 J. Fin. 1857 (2002).

⁸ The legal limit to the corporate governance commitments a company can include in its charter is that it cannot violate federal law or the law of the state in which the firm is incorporated—which, as discussed below, is itself a matter of contract. For example, the Delaware General Corporation Law provides: “(T)he certificate of incorporation may also contain any or all of the following matters: (1) Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders . . . if such provisions are not contrary to the laws of this State.” Del. Code Ann. tit. 8, § 102(b)(1). Regardless of the state of incorporation, the legal constraint on charter terms is not a strong one.

⁹ Easterbrook & Fischel, *supra* note 2, at 6.

¹⁰ For an overview of this issue, see Lucian Arye Bebchuk, The Debate on Contractual Freedom in Corporate Law, 89 Colum. L. Rev. 1395 (1989).

¹¹ Easterbrook & Fischel, *supra* note 2, at 32–34.

¹² *Id.*

¹³ Easterbrook & Fischel, *supra* note 2, at 15; Jonathan Macey, Corporate Law and Corporate Governance: A Contractual Perspective, 18 J. Corp. L. 185, 198 (1993).

¹⁴ Easterbrook & Fischel, *supra* note 2, at 34.

¹⁵ *Id.* at 218, Baysinger & Butler, Race, *supra* note 2, at 556.

¹⁶ Easterbrook & Fischel, *supra* note 2, at 12.

¹⁷ Michael Klausner, *supra* note 7. The sample included 30 companies per year, except for 2008, when there were fewer than 30 IPOs. I omitted spin-offs, carve-outs, blank-check companies, regulated financial institutions, and real estate investment trusts.

¹⁸ Bylaws are not part of a binding contract in the way a charter is. Whereas a charter can be amended only with the approval of the board and the shareholders, bylaws can be amended unilaterally by shareholders, and more importantly for the immediate discussion, by the board so long as the charter allows the board to amend the bylaws, which is universally the case. Nonetheless, I collected data from bylaws as well.

¹⁹ On November 4, 2003, the SEC approved New York Stock Exchange and NASDAQ rules requiring that firms have compensation, nominating/corporate governance, and audit committees consisting entirely of independent directors. Those rules were effective beginning with a company's first annual meeting after January 15,

2004 (or no later than October 31, 2004 if there was not an earlier annual meeting). NASD and NYSE Rulemaking: Relating to Corporate Governance, Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154 (Nov. 12, 2003). In Table 1, I use April 1, 2004 as the relevant starting date for this rule. The SEC's proxy access rule, which was later vacated by the United States Court of Appeals for the District of Columbia Circuit, see *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011), was effective as of November 15, 2010. Facilitating Shareholder Director Nominations, Securities Act Release No. 9136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384, 75 Fed. Reg. 56,668 (Sept. 16, 2010). The SEC's say-on-pay rule became effective on April 4, 2011. Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Securities Act Release No. 9178, Exchange Act Release No. 63,768, 76 Fed. Reg. 6010 (Feb. 2, 2010). It became salient as a governance issue in 2006, when the American Federation of State, County, and Municipal Employees (AFSCME) filed the first shareholder proposal seeking a say-on-pay vote. See [Challie Dunn & Carol Bowie, RiskMetrics Grp., Evaluating US](#)

[Company Management Say on Pay Proposals: Four Steps for Investors 4–5](#)

[\(2009\)](#), available at

http://www.shareholderforum.com/sop/Library/20090316_RiskMetrics.pdf.

²⁰ [Roberta Romano & Sarath Sanga, The Private Ordering Solution to Multiforum](#)

[Shareholder Litigation](#), (December 1, 2015) available at

<http://ssrn.com/abstract=2624951>] The Chancery Court decision was *In re Revlon Shareholders Litigation*, 990 A. 2d 940, 960 (Del Ch. 2010).

²¹. This would be the classic (if circular) contractarian inference: If it is not adopted by firms going public, then it is not value enhancing (and should not be legally required). For example, Easterbrook & Fischel argue that if holding an auction among bidders were the value-maximizing response to a hostile offer, then charter terms would require management or the board to hold an auction, Easterbrook & Fischel *supra* note 2, pp. 204–205. Haddock et al. similarly argued that if management passivity in response to a hostile bid were value maximizing, then provisions mandating passivity would be included in IPO charters. Haddock et al., *supra* note 2, at 728).

²² The reported results would not change if I were to use the time period 2000 to 2012 for all provisions. That is, outside the restricted periods used in Table 1, there were no additional charters or bylaws that contained these provisions.

²³ [Robert Daines](#), [The Incorporation Choices of IPO Firms](#), 77 N.Y.U. L. Rev. 1559 (2002); [Lucian A. Bebchuk & Alma Cohen](#), [Firms' Decisions Where to Incorporate](#), 46 J.L. & Econ. 383 (2003); [Lucian A. Bebchuk et al.](#), [Does the Evidence Favor State Competition in Corporate Law?](#) 90 Cal. L. Rev. 1775, 1820 (2002); [Marcel Kahan & Ehud Kamar](#), [The Myth of State Competition in Corporate Law](#), 55 Stan. L. Rev. 679 (2002).

²⁴ [William C. Johnson et al.](#), [The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms](#), available at <http://ssrn.com/abstract=1923667>; [Martijn Cremers](#),

Lubomir P. Litov, and Simone M. Sepe, Staggered Boards and Firm Value,

Revisited (2014), available at <http://ssrn.com/abstract=2364165>; Weili Ge, Lloyd

Tanlu, & Jenny Li Zhang, Board Destaggering: Corporate Governance Out of

Focus? (2014), available at <http://ssrn.com/abstract=2312565>.

²⁵ Klausner, Fact and Fiction, *supra* note 7, at 352–355.

²⁶ Easterbrook & Fischel, *supra* note 2, at 204–205 (emphasis added).

²⁷ John C. Coates IV, Explaining Variation in Takeover Defenses: Blame the Lawyers,

89 Calif. L. Rev. 1301, 1353 tbl.3, 1377 fig.3 (2001)] (summarizing the results of

four sample periods and noting that defenses became more common in the late

1990s); Daines & Klausner, *supra* note 7, at 96 tbl.2; Laura Casares Field &

Jonathan M. Karpoff, Takeover Defenses of IPO Firms, *supra* note 7, at 1861 tbl.

II (2002). When Rob Daines and I presented a draft of our article at the American

Law and Economics Association annual meeting in 2000, the first response in the

discussion that followed was from a dyed-in-the-wool contractarian who began by

saying: “Well, this is certainly disconcerting.”

²⁸ Daines & Klausner, *supra* note 7, at 98–99; Field & Karpoff, *supra* note 7, at 1857–

1858.

²⁹ Daines & Klausner, *supra* note 7, at 102.

³⁰ See sources cited at note 26.

³¹ This discussion is based on Michael Klausner, Corporations, Corporate Law, and

Networks of Contracts, 81 Va. L. Rev. 757, 826–829 (1995). Marcel Kahan and I

suggested additional attractions of commonly used terms. One is based on a

herding dynamic associated with principal–agent relationships—in this context the relationship between a firm’s lawyers and the firm. Another is based on cognitive biases. See [Kahan & Klausner, Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases](#), 74 Wash. U. L. Q. 347 (1996).

³² The quality of the Delaware judges can be viewed as a complementary service that developed as a result of the widespread use of Delaware law.

³³ Two firms whose particular governance needs were very different from those of the typical public company are Visa and Mastercard, each of which went public with highly customized governance arrangements. In each case, banks had ownership and interests and governance rights that were different from those of public shareholders. Visa, Inc., Registration Statement (Form S-1) (Mar. 19, 2008) (allocating separate classes of stock with limited voting rights to bank shareholders with pre-IPO ownership rights); Mastercard Inc., Registration Statement (Form S-1) (25 May, 2006) (similar to Visa’s arrangement but also giving bank shareholders with pre-IPO ownership power to elect up to three directors).

³⁴ If the market for management talent is perfect, staggered boards would increase shareholder value under these conditions because manager with high private benefits would accept lower compensation. But there are reasons to believe the market for management talent is not so perfect.

³⁵ Coates, *supra* note 7, at 1381–1382. I too have heard many market participants express this view.

³⁶ Ron Gilson and Bernie Black, extending an argument they made regarding implicit contracting between VCs and entrepreneurs, might argue that VCs will incur this cost as part of an implicit deal they have with entrepreneurs to return control to them if they are successful. See [Ronald Gilson & Bernard Black, 47 J. Fin. Econ. 243 \(1998\)](#). Evidence against this explanation is that only some VC-backed companies go public with staggered boards.

³⁷ Bebchuk, *supra* note 10, at 1399.

³⁸ [Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416, 1443 \(1989\)](#). In their book (p. 34), they say “It is important, however, to keep the latecomer term (a contract term added unilaterally by management) in mind as a potential problem in a contractual approach to corporate law.” In other articles, many of which were included in the *Columbia Law Review* symposium issue, legal scholars spelled out the weaknesses of the contractarian arguments at the midstream stage. [Robert C. Clark, Contracts, Elites, and Traditions in the Making of Corporate Law, 89 Colum. L. Rev. 1703 \(1989\)](#); [John C. Coffee, Jr., The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role, 89 Colum. L. Rev. 1618 \(1989\)](#); [Melvin Aron Eisenberg, The Structure of Corporation Law, 89 Colum. L. Rev. 1461 \(1989\)](#); [Jeffrey N. Gordon, The Mandatory Structure of Corporate Law, 89 Colum. L. Rev. 1549 \(1989\)](#); see also [Lucian Arye Bebchuk, Limiting Contractual Freedom in Corporate Law: The](#)

[Desirable Constraints on Charter Amendments](#), 102 Harv. L. Rev. 1820, 1848

(1989).

³⁹ Easterbrook & Fischel, *supra* note 2, at 33; Haddock et al., *supra* note 2, at 727–730; Macey, *supra* note 2, at 193.

⁴⁰ See e.g., Easterbrook & Fischel, *supra* note 2, at 32–33; Baysinger & Butler, Role of Corporate Law, *supra* note 2, at 182; Baysinger & Butler, Race, *supra* note 2, at 448–451.

⁴¹ Easterbrook & Fischel, *supra* note 2, at 167–174.

⁴² Haddock et al., *supra* note 1, at 737. In another article, Macey and McChesney state:

“The ‘market for managers’ penalizes management teams who try to advance their own interest at shareholders’ expense.” [Jonathan R. Macey & Fred S.](#)

[McChesney](#), [A Theoretical Analysis of Corporate Greenmail](#), 95 Yale L.J. 13, 40

(1985). As was true of other legal scholarship at the time, they offered no empirical support for this statement. In their original article on management responses to hostile takeovers, Easterbrook & Fischel advocated a mandatory legal rule of passivity. Easterbrook & Fischel, *supra* note 26, at 1164. In their book, ten years later, they remained doubtful that a contractual approach would work, but changed their position to one in which the default rule would require passivity. Easterbrook & Fischel, *supra* note 1, at 174 (“(T)he optimal legal rule prevents resistance unless expressly authorized by contract ex ante.”).

⁴³ Daines & Klausner, *supra* note 7, at 95; Coates, *supra* note 7 at 1357. The sample of charters on which I report above also contain no limitations on charter amendments favoring management.

⁴⁴ For example, among firms whose bylaws provided for a staggered board, half required a supermajority vote as high as 80% to amend the bylaws to get rid of the staggered board.

⁴⁵ Georgeson, a provider of strategic shareholder consulting services, has made available online a series of annual reports that provide a useful chronology of shareholder proposals. See Annual Corporate Governance Review, Georgeson, <http://www.georgeson.com/us/resource/Pages/acgr.aspx> (last visited May 11, 2013).

⁴⁶ Klausner, *supra* note 7, at 757–762.

⁴⁷ *Id.* at 758 & n.7, 759 tbl.2.

⁴⁸ Sarbanes–Oxley Act of 2002, Pub. L. 107–204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

⁴⁹ See [Robert Daines, Ian Gow, & Robert F. Larcker, Rating the ratings: How good are commercial governance ratings?, 98 J. Fin. Econ. 439 \(2010\).](#)

⁵⁰ See Order Approving NYSE and NASDAQ Proposed Rule Changes Relating to Equity Compensation Plans, Exchange Act Release No. 48,108, 68 Fed. Reg. 39,995 (July 3, 2003).

⁵¹ See NASDAQ Stock Market Rules § 5605(b)(2) (2013); NYSE, Listed Company Manual § 303A.03 (2013).

⁵² [David Larcker & Brian Tayan, Corporate Governance Matters: A Closer Look at Organizational Choices and their Consequences](#) 136–139 (2011).

⁵³ See Sarbanes–Oxley Act § 301; NASDAQ, *supra* note 51, § 5605(c)–(e); NYSE, *supra* note 51 § 303A.04-.07. Prior to Sarbanes–Oxley, the stock exchanges imposed some independence requirements in audit committees.

⁵⁴ NYSE, Inc., Listed Company Manual § 303A.04-.05. Stock ex.

⁵⁵ NASDAQ, Inc. Rule 5605(d)–(e).

⁵⁶ Some argue that shareholders have too much power and that they wield it in ways inconsistent with their long-term interest. I take no position on that issue.

⁵⁷ [John E. Core & Wayne R. Guay, Is Pay too High and Are Incentives too Low: A Wealth-Based Contracting Framework](#), 24 *Acad. Mgt Persp.* 5–19 (2010).

⁵⁸ [Marcel Kahan & Edward Rock, Embattled CEOs](#), 88 *Tex. L. Rev.* 987, 998–1001 (2010), at 996–997.

⁵⁹ Kahan & Rock, *supra* note 59; [Ronald Gilson & Jeffrey Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights](#), 113 *Col. L. Rev.* 883 (2013); [Ronald Gilson & Jeffrey Gordon, Agency Capitalism: Further Implications of Equity Intermediation, in Research Handbook on Shareholder Power](#) (J. Hill & R. Thomas eds., 2015).

⁶⁰ In some forms of majority voting, a director may not take his seat if he or she does not get a majority of votes, and in others the director must tender a resignation, which the board is free to accept or reject.

⁶¹ [Claudia H. Allen, Study of Majority Voting in Director Elections \(2007\)](#), available at

<http://www.ngelaw.com/files/Uploads/Documents/majoritystudy111207.pdf>.

⁶² Kahan & Rock, *supra* note 59, at 1011 tbl.3.

⁶³ [Yonca Ertimur, Fabrizio Ferri, & David Oesch, Does The Director Election System](#)

[Matter? Evidence from Majority Voting, 29–31](#) available at

<http://ssrn.com/abstract=1880974>.

⁶⁴ Firms with majority voting tend to implement successful shareholder proposals more than firms with plurality voting. In addition, when shareholders withhold votes as a means of expressing dissatisfaction with a general governance matter, as opposed to dissatisfaction with a particular director, firms with majority voting are more likely to address the matter than firms with plurality voting. *Id.* At 15, 20–22, 25–27; see also [Jay Cai, Jacqueline L. Garner, & Ralph L. Walkling, A Paper Tiger? An Empirical Analysis of Majority Voting, 21 J. Corp. Fin. 119, 129–130 \(2013\)](#) (finding a positive price reaction to the announcement of a proposal to adopt majority voting).

⁶⁵ See [Re-Jin Guo et al., Undoing the Powerful Anti-Takeover Force of Staggered Boards, 14 J. Corp. Fin. 274](#), 278 fig.1 (2008) (hereinafter *Undoing the Takeover Force of Staggered Boards*); [Re-Jin Guo, Timothy A. Kruse, & Tom Nohel, Activism and the Shift to Annual Director Elections 30 fig.1 \(CELS Version, Nov. 2012\)](#) (on file with author).

⁶⁶ [Edward Rock, Adapting to the New Shareholder Centric Reality, 161 U. Pa. L. Rev. 1907 \(2013\)](#); Marcel Kahan & Edward Rock, *supra* note 59; [Marcel Kahan &](#)

Edward Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155

U. Pa. L. Rev. 1021 (2007) (hereinafter, *Hedge Funds*).

⁶⁷ See *id.* at 1022.

⁶⁸ *Id.* at 1022–1032.

⁶⁹ See, e.g., *Business Roundtable, Letter to SEC on Proxy Access*, September 14, 2009,

available at <http://businessroundtable.org/resources/business-roundtable->

[statement-on-the-presidents-remarks-on-financial-regula](http://businessroundtable.org/resources/business-roundtable-statement-on-the-presidents-remarks-on-financial-regula); *Martin Lipton, Steven*

A. Rosenblum, & Karessa L. Cain, Proxy Access Revisited, 44 *Bank and Corp.*

Gov. L. Rep. 499 (2010); Letter from Wachtell, Lipton, Rosen, & Katz to

Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Aug. 17,

2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-263.pdf>;

Stephen Bainbridge, Corporate Governance after the Financial Crisis (2012);

Stephen Bainbridge, Dodd–Frank: Quack Federal Corporate Governance Round

II, 95 *Minn. L. Rev.* 179 (2011).

⁷⁰ <http://www.professorbainbridge.com/professorbainbridgecom/2010/06/gut-proxy->

[access.html](http://www.professorbainbridge.com/professorbainbridgecom/2010/06/gut-proxy-access.html). Professor Michal Barzuza has responded with an adverse selection

theory of governance choice that undermines the “one size does not fit all”

argument. *Michael Barzuza, No-Size-Fits-None: Adverse-Selection and*

Inefficient Self-Selection in Private Ordering of Corporate Law and Governance

(draft, August 12, 2015).