

I. INTRODUCTION

U.S. firms can choose many of the legal terms that govern them. They can choose whether to adopt poison pills, staggered boards, golden parachutes, majority voting, proxy access, directors' indemnification and protection from liability, a joint chairman and CEO, and a lead independent director. They also choose their governing corporate law by selecting the state in which to incorporate. Underlying this enabling approach is the assumption that if insiders adopt entrenching, inefficient terms—that is, bad governance—they risk a market penalty in the form of a lower share price.¹

Much hinges, therefore, on the accurate pricing of governance terms. This Article identifies and analyzes obstacles to the pricing of governance terms. First, it argues that the value of governance terms varies across companies due to unobservable differences in market forces that firms face. While in some companies managers could use protective terms such as staggered boards or plurality voting for entrenchment purposes, managers in other companies face significant competition, difficult capital markets, or significant pressure from potential buyers, which discipline them regardless of their companies' governance structure. Thus, in order to evaluate the value of governance terms, investors need information about the strength of the market forces to which each firm is subject.

Information about the exact magnitude of the market forces that each firm faces, as well as the exact amount of private benefits that each manager may extract as a result of such forces, is not fully observable, however. While investors might have information on the strength of competition in a particular industry, for example, it is unlikely they could determine with precision the exact level of competition that each firm in the industry faces.

Yet, theoretically, even though firm heterogeneity is not completely observable, firms could signal information about their type via their choice of governance terms. For instance, by adopting a non-classified board, proxy access, majority voting, or other relatively strict governance terms, managers could signal that they face strong market forces and, accordingly, extract only low private benefits. Similarly, the choice of entrenching terms could signal management's weak market discipline.²

Further complicating the picture, however, is the fact that a substantial number of firms, termed "noise adopters" by this Article, pay little attention to their corporate governance. These firms make corporate governance choices for non-substantive reasons, such as the idiosyncratic preferences of their legal counsel, network externalities, or mere inertia.³

Noise adopters, this Article argues, can obscure an otherwise clear signal of a manager's preference for entrenchment. Investors who are unsure whether management adopted a staggered board due to its interest in entrenchment, or because a staggered board was part of a boilerplate

¹ See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1432 (1989) ("Governance structures are known to anyone seeking the information, so the pricing mechanism will embody their effects for good or ill.").

² As explained below, managers who face weak market forces have a stronger interest in terms that protect their extraction of private benefits. As a result, the costs of dropping entrenching terms are larger for these managers than for those who face strong market discipline.

³ Noise adopters have been recognized by the literature. See, e.g., John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1337–39 (2001) (finding that geographic location of law firms predicts IPO firms' adoption of antitakeover terms); Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1584–85 (2002) (finding that existence of a national law firm practice predicts firms' incorporation in Delaware); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 761 (1995) (arguing that adoption of legal terms creates value that is independent from their legal substance, as it imposes positive network externalities).

provided by the advising law firm, attach only a partial discount to this choice. The noise, therefore, provides camouflage to managers with a strong interest in entrenchment.

The noise adopters concept builds on Albert Kyle's seminal paper on noise traders in capital markets and their role in camouflaging insider trading.⁴ In Kyle's model, noise traders sell and buy securities randomly, regardless of fundamentals.⁵ Their activity obscures trades by informed traders and allows the latter to capitalize on inside information.⁶ Similarly, by incorporating Kyle's idea of the importance of random behavior to the signaling insights pioneered by Michael Spence,⁷ this Article shows that the noise adopters of corporate governance provide camouflage to managers who prefer for entrenchment.

Noise adopters allow expropriating managers to avoid the full costs of their (poor) corporate governance choices. For example, assume that there are two types of companies: a high agency costs (or "bad") type, Company A, and a low agency costs (or "good") type, Company B. Assume that the managers' extraction of private benefits reduces firm value by ten percent in Company A, but only by two percent in Company B, where extraction is limited.⁸

Assume further that both firms choose to adopt a staggered board, which provides them with strong protection from hostile takeovers, and as a result protects their private benefits. If investors cannot distinguish these companies they will attach a discount of six percent to both firms. Company B's managers, however, who face strong market forces, extract small amounts of private benefit and therefore need a staggered board less than managers of Company A do. As a result, Company B may remove its staggered board. If that happens, investors would attach a ten percent discount to firm A, which might in turn drop its staggered board, too. Assume, however, that a third firm, Company C, adopts a staggered board for reasons that have nothing to do with a preference for private benefits, such as the advice of a law firm. If there is a fifty percent likelihood that Firm C is bad, investors will discount the value of both Company A and C by eight percent instead of ten percent. Since entrenching terms are priced at a discount when noise adopters are present, entrenchment-seeking managers are more likely to adopt such terms than they would in the absence of noise adopters.

Noise adopters therefore affect the patterns of adoption of governance terms. This Article analyzes implications for the type of market equilibrium that emerges. First, with noise adopters, a pooling equilibrium on strict governance (where no firm adopts a staggered board) is less likely to emerge. In fact, due to noise adopters, a separating signaling equilibrium (where some firms adopt a staggered board and some do not) or a pooling on lax governance (where all firms adopt a staggered board) are more likely. Since the informational quality of a staggered board signal is watered down—that is, it does not necessarily suggest that all such firms are of the bad type—it carries only a partial market discount. As a result, the motivation of bad firms to imitate good firms by adopting a non-classified board is reduced relative to what it would have been in information-efficient markets. The existence of noise adopters also increases the likelihood of a pooling equilibrium in which all firms adopt entrenching terms. The motivation of good firms to commit to better law decreases since that signal's value is weakened. Thus, the noise adopters theory helps explain the persistence of inefficient behavior, such as the widespread adoption of staggered boards and home state incorporations, even though these choices are associated with some discount to firm value.

⁴ See Albert S. Kyle, *Continuous Auctions and Insider Trading*, 53 *ECONOMETRICA* 1315 (1985).

⁵ See Kyle, *supra* note 4, at 1315.

⁶ See *id.* at 1315–16.

⁷ See Michael Spence, *Job Market Signaling*, 87 *Q. J. ECON.* 355 (1973).

⁸ For a discussion of why entrenching terms cause more harm in firms with high agency costs, see *infra* Part IV.A.

Second, the noise adopters theory helps reconcile observed differences between IPO and midstream investor behavior. The literature has been puzzled by firms' adoption of inefficient governance terms—such as staggered boards and home state incorporation—at the IPO stage when they would not be able to implement such terms if their shares were already publicly traded.⁹ Despite investors' reluctance to implement staggered boards and pressure to declassify staggered boards in publicly-traded firms, between 2009–11, almost eighty percent of the largest fifty U.S. company IPOs had staggered boards.¹⁰ Similarly, while many IPO companies choose to incorporate in their home states, when Abercrombie & Fitch, a publicly traded-company, attempted to reincorporate from Delaware to its home state of Ohio, shareholder resistance and negative publicity forced management to abandon the proposal.¹¹

Why is it that the same institutional shareholders who vote against the adoption of certain corporate governance terms midstream nevertheless routinely accept those very same terms when proposed at the IPO? Under the noise adopters theory, an IPO sends a mixed signal of firms' choices. Given the prevalence of staggered boards in IPO filings, it is possible that management did not specifically select that structure. Similarly, for the several thousand firms that are incorporated in their home state, investors do not know whether to infer that management was interested in home state protection, or instead to conclude that the choice was the benign result of factors like inertia or the advice of a local lawyer. However, when management proactively seeks to adopt a corporate governance term midstream, it reveals its preference for strong protection.

Finally, the noise adopters theory has unique predictive power in explaining investors' reactions to new information. For example, incorporation in Nevada—a state with highly entrenching corporate law—is not associated with a negative price reaction,¹² yet financial restatements in Nevada are associated with a particularly strong market penalty.¹³ Under the noise adopters theory, a firm could choose a state with a lax law for a variety of reasons—some seek entrenchment while others' choices are more random.¹⁴ When adverse events occur in companies incorporated in states with lax laws, investors are more likely to attribute the incorporation choice to protectionist motives and not benign reasons. Thus, the noise adopters theory predicts that investors' reactions to news could be influenced by the type of governance the firm had previously adopted.

One remaining unanswered question is what explains the survival of noise adopters. If governance terms lead to even a small value discount, noise adopters should have incentives to adopt governance terms only if they are really interested in them. This Article discusses potential

⁹ See Michael Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755, 755–56 (2003).

¹⁰ See DAVIS POLK & WARDWELL LLP, GOVERNANCE PRACTICES FOR IPO COMPANIES: A DAVIS POLK SURVEY (Oct. 31, 2011), http://www.davispolk.com/sites/default/files/files/Publication/d9986f4c-50b7-4947-b745-062305dd1876/Preview/PublicationAttachment/7072f391-ba79-4939-a663-06a61269bf87/103111_gorp.gov.html. See also Steven M. Davidoff, *The Case Against Staggered Boards*, N.Y. TIMES DEALBOOK (Mar. 20, 2012, 12:43 PM), <http://dealbook.nytimes.com/2012/03/20/the-case-against-staggered-boards/> (discussing the growing prevalence of staggered boards, noting that over eighty-six percent of IPOs to that point in 2012 featured staggered boards).

¹¹ See Steven M. Davidoff, *Abercrombie Ohio Express*, N.Y. TIMES DEALBOOK (Dec. 24, 2010, 4:06 PM), <http://dealbook.nytimes.com/2010/12/23/abercrombies-ohio-express/>; Tim Feran, *Abercrombie Scuttles Investor Vote on Ohio Reincorporation*, COLUMBUS DISPATCH, Mar. 1, 2011, <http://www.dispatch.com/content/stories/business/2011/03/01/abercrombie-scuttles-investor-vote-on-ohio-reincorporation.html>.

¹² See Michal Barzuza & David Smith, *What Happens in Nevada? Self-Selecting into Lax Law* 6 (Va. Law and Econ. Res. Paper No. 2011-08, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1644974.

¹³ See *id.* at 26.

¹⁴ See *id.*

explanations and proposes that network and learning externalities contribute to the endurance of noise adopters. However, further investigation is needed to answer this question fully.

The analysis proceeds as follows. Part II discusses the types and sources of noise adopters. Part III provides an example of the effect of noise adopters on price and patterns of adoption. Part IV shows how the analysis helps to explain the puzzling patterns and pricing for governance terms.

Part V discusses the implications of the noise adopters theory. Conventional wisdom views choices at the IPO stage as efficient, believing that founders adopt governance terms efficiently to maximize IPO share value. This Article suggests that this is not always the case and that the information asymmetries that characterize IPOs may make pricing governance terms challenging. Thus, an accurate application of the Efficient Capital Markets Hypothesis (“ECMH”) would not suggest that market prices reflect the real value of corporate governance terms such as staggered boards, poison pills, and state of incorporation. Rather, a more realistic application of the ECMH to corporate governance terms must account for investors’ ignorance about the real reasons why a company adopts a particular governance term. Since noise adopters obscure these reasons, the assumption that firms fully internalize this choice should be replaced with a more cautious approach. Deviation from the assumption that voluntarily-adopted terms are efficient does not necessarily suggest that mandatory laws should regulate governance terms. Rather, it could suggest, for example, that courts apply higher scrutiny to entrenching structures such as staggered boards. Finally, this Article suggests that robust disclosure obligations that include the circumstances and particular reasons for choosing governance terms could mitigate, though likely not eliminate, noise created by noise adopters.

The introduction of noise traders to finance has transformed the finance literature, contributing to a richer and more realistic analysis of capital markets.¹⁵ The legal literature has recognized that firms may be arbitrarily adopting corporate governance terms.¹⁶ This Article suggests that the practice plays a role in obscuring adoption of governance terms for entrenchment purposes.

¹⁵ See generally Andrei Shleifer & Lawrence H. Summers, *The Noise Trader Approach to Finance*, 4 J. ECON. PERSP. 19 (1990) (using noise trader approach to explain certain anomalies in the financial markets).

¹⁶ See note 3 and accompanying text.