NOISE ADOPTERS IN CORPORATE GOVERNANCE

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This Article argues that "noise adopters," namely firms whose corporate governance is determined by non-substantive factors such as attorneys' boilerplates, network externalities, and mere inertia, provide camouflage to insiders with a strong preference for entrenchment. Normally, a deliberate choice of entrenching governance terms would signal weak market discipline and high extraction of private benefits. Yet, since some firms stagger their boards or incorporate in their home state for reasons having little to do with firm operations or strategy, these choices send only a noisy signal, and in turn result in only a partial market discount of firm value. Entrenchment-seeking managers can achieve their desired level of entrenchment without paying a full price.

This analysis highlights informational limits on markets' ability to perfectly price corporate governance terms. The value of governance terms varies across firms due to unobservable variations in market forces and potential signaling is obscured by practices of random adoption.

Noise adopters influence patterns of adoptions and help explain puzzling evidence regarding pricing and adoption of governance terms.

I. Introduction 628
II. Corporate Governance, Firm Heterogeneity, and Signals 636
A. A Contractual Approach to Corporate Governance 636

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B. Corporate Governance Value Varies due to Differences in Market Forces 637
C. Asymmetric Information 641
D. Signaling 642
1. Adverse Selection and Signaling Theory 642
2. Strict Governance as a Signal of Strong Market Descipline 645
III. Noise Adopters and Noisy Signals 648
A. Noise Adopters 648
B. Noise Adopters and Noisy Signals 651
C. Noisy Signals Encourage "Bad" Firms to Choose Protective Law 653
D. Noisy Signals Reduce the Incentives of "Good" Firms to Choose Good Law 654
E. How Noise Adopters Change Equilibria's Likelihood 655
F. Information Bits and Updating Investors' Beliefs 655
G. What Explains Noise Adopters' Survival? 656
IV. Explaining Puzzles and Reconciling Evidence 657
A. Explaining the IPO vs. Midstream Puzzle 657
B. Evidence on How Investors Update Their Beliefs 661
V. Implications 662
A. Consequences for ECMH Theory and Contractual Freedom in Corporate Law 662
B. Consequences for Disclosure Obligations 664
VI. Conclusion 665

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

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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.").

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 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

[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).

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

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

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.

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.

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

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

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.

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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 prevalance 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.

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 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

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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.*

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.

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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.

II. CORPORATE GOVERNANCE, FIRM HETEROGENEITY, AND SIGNALS

A. A Contractual Approach to Corporate Governance

For the most part, corporate law in the United States is about corporate governance—the division of power and rights in the corporation. It is also characteristically enabling. Corporations are generally free to design their governance structures. They can adopt takeover defenses such as poison pills, staggered boards, and golden parachutes.[17] They can also incorporate in, and thus choose the legal system of, any state. State laws differ in the potency of their takeover statutes and in the degree to which they defer to management's use of defensive tactics. Firms are also largely free to design their own voting rules: they can choose whether or not to have a proxy access rule[18] and to institute plurality or majority voting.[19] Firms also have freedom to choose their board structure and size, to design management compensation schemes, and to have a joint CEO and chairman of the board. They can also choose to opt out of the duty of care[20] and can even opt out of a considerable part of their duty of loyalty if they incorporate in Nevada.[21] The enabling approach reflects the contractual view of the firm, which asserts that, as with transactional contracts, allowing the parties to design their own corporate contracts is more efficient than imposing mandatory contract rules on them.[22] Corporate law under this approach should provide only a default set of contracts, not mandatory terms.

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17 DEL. CODE ANN. tit. 8, § 141(d) (2013).

18 *See id.* § 112.

19 *See id.* § 216.

20 *See id.* § 102(b)(7) (2013).

21 *See* NEV. REV. STAT. § 78.138(7) (2013). *See also* Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA. L. REV. 935, 950 (2012).

22 *See, e.g.*, Easterbrook & Fischel, *supra* note 1, at 1432; Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 882 (1983); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 292

Firms' governance choices, however, involve a common tension. Insiders may have preferences for entrenching governance terms even if they reduce firm value.[23] Yet, underlying the contractual approach is the assumption that firms internalize the costs of their choices via the price of their shares in the capital markets. Applying the ECMH—which asserts that the capital markets reflect the real value of public information—to the pricing of publicly-disclosed governance terms, contractual scholars argue that a price discount due to inefficient terms should discipline companies who make inefficient governance choices.[24] To be sure, market penalties are not always sufficient to incentivize management not to adopt excessive terms. In fact, in some firms, management's private benefits might outweigh the adverse effects of the market penalty. Even if companies are not always disciplined by the penalty, however, at least investors are knowledgeable about their investments.[25] Thus, much hinges—theoretically and in terms of policy—on the efficiency of capital markets in pricing governance terms.

B. Corporate Governance Value Varies due to Differences in Market Forces

Assessing the value of corporate governance terms, however, is complicated by the fact that their value depends

(1977). Several works have expressed skepticism about this view. *See* Lucian A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1412 (1989) [hereinafter Bebchuk, *Debate on Contractual Freedom*]; Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: the Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1859–60 (1989); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1411 (1985).

23 *See, e.g.*, Bebchuk, *Debate on Contractual Freedom*, *supra* note 22, at 1400–01, 1411.

24 *See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395, 414 (1983). *Cf.* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 554 (1984) (demonstrating forcefully that market efficiency varies with, and is a function of, the performance of different institutions).

25 *See id.* at 415.

on firm-specific characteristics. This Article focuses on one source of heterogeneity: variations in market forces. Different markets, such as the product market and the market for corporate control, discipline management. Managers who face strong competition in the product market must manage efficiently and avoid taking perks. Otherwise, they may experience losses in the product market or lose control to a hostile bidder. Indeed, market forces are one of the main justifications for the enabling approach. Accordingly, the debate over the desirability of the enabling approach has turned on whether market forces are sufficiently effective.[26]

The effectiveness of market forces in disciplining management, however, varies across firms. Firms differ in the competition they face in the product market, in the labor market conditions for their management, and in their likelihood of being acquired by another company—and, in turn, in their likelihood of being disciplined by the market for corporate control.[27]

As a result, this part argues, governance terms' use and effect also vary across firms. Since market forces limit private benefits, they also limit the use and effect of governance terms. In firms that face significant market force discipline, managers are less likely to take advantage of entrenching corporate governance terms. Even if the firm had a staggered board, and managers were therefore less concerned about hostile takeovers, managers who face fierce competition would still have to manage the firm efficiently to ensure the firm's survival. Conversely, if a firm operates in a concentrated industry, monopolistic profits leave a margin for slack. Managers may extract perks, manage less

26 *See, e.g.*, Bebchuk, *Debate on Contractual Freedom*, *supra* note 22, at 1401 n.32. The debate, however, did not focus on the potential influence of market forces on the uses, effects, and value of governance terms.

27 *See e.g.*, Barry D. Baysinger & Henry N. Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431, 450–51 (1985) (stating generally that the market forces mechanism entails transaction costs, and as a result reliance upon market incentives will be appropriate only in some firms).

efficiently, or make unwise decisions without risking the company's existence. For these managers, it will matter significantly whether the firm has a staggered board. The threat of a hostile takeover could provide the discipline that the product market lacks.

Take competition in the product market, which has long been recognized as constraining managers' agency costs.[28] The exact level of competition a firm faces varies across industries and, within industries, across firms. Some industries have higher barriers to entry than others.[29] Some products have closer substitutes than others. Variation in competition translates to variation in private benefits for managers.[30] A recent study found that the control premium—a common indicator for extraction of private benefits—is lower in competitive industries.[31] In competitive industries, in other words, insiders can extract less from their firms because demand for those products and services is more elastic.

Accordingly, variation in competition also translates to variation in entrenching terms' use and effect. As a recent study found, weak governance is only associated with lower value and worse performance in noncompetitive industries.[32] In competitive industries there is no significant difference

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28 *See* Winter, *supra* note 22, at 263–64.

29 *See generally* MICHAEL E. PORTER, COMPETITIVE STRATEGY: TECHNIQUES FOR ANALYZING INDUSTRIES AND COMPETITORS 7–13 (1980) (discussing how industries' structural characteristics affect the level of competition).

30 *See* Mark J. Roe, *Rents and Their Corporate Consequences,* 53 STAN. L. REV. 1463, 1476 (2001) (arguing that increased monopoly rents induce higher potential agency costs).

31 *See* Maria Guadalupe & Francisco Perez-Gonzalez, Competition and Private Benefits of Control 15–17 (Mar. 2010) (unpublished article), *available at* http://ssrn.com/abstract=890814; Maria Guadalupe & Francisco Perez-Gonzalez, *The Impact of Product Market Competition on Private Benefits of Control* 4 (Inst. of Econ. Research, Hitotsubashi Univ. Discussion Paper No. 159, 2006), *available at* http://hermes-ir.lib.hit-u.ac.jp/rs/bitstream/10086/13564/1/D05-159.pdf.

32 *See* Xavier Giroud & Holger M. Mueller, Corporate Governance, Product Market Competition, and Equity Prices, 66 J. FIN. 563, 563 (2011).

between the performance of firms with strong and weak governance.[33]

Other market forces also vary across companies. Take, for example, the managerial labor market that arguably penalizes managers who do not perform well.[34] The extent to which firm performance affects the hiring and firing of managers varies across firms. Firm performance is noisy—many factors affect it, of which managers' performance is only one. Some industries are noisier than others, and some firms are more transparent than others. In some industries managerial positions are more competitive than in others, and the likelihood of finding a new job is lower. Thus, for some firms, it is easier to relate the firm's success or failure to managerial performance than for other firms.

Similarly, the market for corporate control—an important disciplinary force for managers—varies across firms. If managers do not perform well, share price should consequently fall and make a hostile bid more likely.[35] Some firms, however, are relatively difficult to acquire—because of their size, financial structure, or operations. Indeed, takeover bid rates vary across industries. Furthermore, the

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33 *See* Giroud & Mueller, *supra* note 32, at 565.

34 *See* Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 554–55 (1984); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 919 (1982).

35 Private benefits may also vary across managers. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112–13 (1965); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 265–66 (1967). For instance, managers may have different opportunities to extract private benefits. If, for example, the manager has other businesses that are related to the company's business, it is more likely that he will have more opportunities for self-dealing. Similarly, managers may vary in their preferences for private benefits. Some may have more inhibitions than others, and as a result, may limit their extraction of private benefits even when external limitations—such as market forces—are relatively weak. While this Article focuses on differences in market forces, the framework developed here may extend to differences in managers' preferences for or opportunities to extract private benefits.

number of potential bidders is often limited to a small few that have synergies with the target. The extent of such synergies also varies across firms. Accordingly, the disciplinary effect of the market for corporate control varies depending on these factors.

C. Asymmetric Information

Given the considerable variations in different market forces, investors need firm-specific information to assess the value of governance terms and price them correctly. Yet, there is one important obstacle for accurate firm-specific pricing: differences between firms are not completely observable to markets. Investors do not know exactly what competition each firm faces, or the managerial prospects in the job market. They also cannot observe the exact level of private benefits that managers extract as a result of the market forces they face.

To be sure, some differences in market forces are observable to investors. For instance, investors (or at least the professionals among them) often have information on an industry's level of competitiveness. As a result, investors may have some sense of the relative level of private benefits extracted in different industries. However, even if investors have some information on firms' constraints, managers have more—and better—information. For instance, managers can better assess the exact level of competition that their firm faces. They also know the exact amount of private benefits they extract as a result of those constraints. In other words, information about the firm is asymmetric, since managers and investors are not equally informed.

Information economics has developed powerful tools to analyze situations in which actors on one side of the market have more information than actors on the other side. The following part will discuss these tools and their applications to adoption of governance terms by firms that face varying unobservable degrees of market forces.[36]

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36 The founders of information economics, George Akerlof, Michael Spence, and Joseph Stiglitz, received the 2001 Nobel Prize in economics

D. Signaling

1. Adverse Selection and Signaling Theory

In basic models of markets with asymmetric information, each actor has private information on his own type, but others know only the distribution of types in the population. For example, in George Akerlof's seminal lemon market for cars, buyers and lenders know that there are "good" types and "bad" types. They also know the proportion of good and bad types. However, when they observe a *specific* car, they do not know if it is of the good or the bad type.[37] Akerlof's powerful insight is that these circumstances result in adverse selection and customers are willing to pay only an average price. Owners of good cars are not willing to sell at this price and, consequently, the average price decreases. Under certain assumptions the market may unravel.[38]

Now take firms who face weak and strong market forces and, consequently, high and low agency costs. If investors have no indication of where a specific firm lies in the distribution, they apply an estimate that reflects an averaging across the good types (here, low agency cost firms) and bad types (here, high agency cost firms).[39] This probability will equal the proportion of the type in the population. Thus, if 40% of the firms are good firms, investors will have an *a priori* belief that the probability that each firm is good is 40%. Assuming that the value of good firms is 100 and that the value of bad firms is 50, investors will value each firm at 70 (40% * 100 + 60% * 50). This market price overestimates the value of bad firms and

for forming the core of the field. As the press release announcing the prize describes, the applications of their insights are abundant. *See* Press Release, The Royal Swedish Academy of Sciences, NOBELPRIZE.ORG (October 10, 2001), http://www.nobelprize.org/nobel_prizes/economics/laureates/2001/press.html.

37 *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 489 (1970).

38 *Id.* at 490–91.

39 *See id.*

underestimates the value of good firms.[40] Like in Akerlof's lemon car market, market undervaluation of firms may cause firms of the good type to leave the market; owners would rather enjoy the full value of one hundred rather than sell for seventy. Once good firms exit, the mix of good and bad firms in the market changes, and investors reduce their tender price to reflect the new average value of firms in the market. In severe situations of information asymmetry, as Akerlof suggested, the market may unravel.[41] Adverse selection in capital markets contributed to the enactment of the Securities Act of 1933 and Exchange Act of 1934.[42] The Acts followed a downsizing market in which investors, with less information than firms' managers, gradually lost their trust in publicly-traded firms. To increase trust and prevent the market from unraveling, the Acts required firms to disclose more information to investors.[43] The remedy reflected the concern about the potential influence of asymmetric information.

There is, however, a potential solution to the adverse selection problem in the form of a signaling equilibrium, in which good types take costly actions to signal their type. Michael Spence developed the idea that under certain assumptions, participants could signal their type.[44] Spence initially used his framework to explain employment equilibrium under asymmetric information. When employers are interested in hiring talented workers but do not know how to recognize them, they offer an average salary, which could lead to adverse selection. Yet, Spence suggested, talented people could credibly signal their type to employers by going to college.[45] To be sure, going to college is costly, but it could be worthwhile if it would help talented

40 *See* Akerlof, *supra* note 37, at 488.

41 *See id.*

42 *See* Alena Allen, *Regulating Health and Wealth*, 35 CARDOZO L. REV. 309, 320 (2013).

43 *See The Laws that Govern the Securities Industry*, SEC, http://www.sec.gov/about/laws.shtml (last visited Dec. 2, 2013).

44 *See* Spence, *supra* note 7, at 358.

45 *See id.* at 357.

employees distinguish themselves. But why would college constitute a credible signal for talent? And why wouldn't less talented employees also go to college? The reason is that even though less talented people may want to imitate the talented ones, the costs of completing college are higher for less talented employees.[46]

More generally, Spence's framework suggests that, with asymmetric information, "good" types may signal that they are good by undertaking costly actions that are more costly for "bad" types to take.[47] In order for signaling to be successful, signaling costs must be higher for bad types than for good types.[48] In fact, they have to be high enough that the bad type finds it not worthwhile to imitate the behavior of the good type, even though its failure to do so would expose its true type.[49]

Finally, the last component of successful signaling focuses on the beliefs of the receiver of the signal. Employers believe that those who go to college of are of the good type because, in equilibrium, they know the costs of signaling. When this occurs, a "separating equilibrium" emerges, in which each type sends a different signal.

Spence recognized that signaling will not always occur.[50] Bad type actors may sometimes choose to imitate the good type actors' signals. For instance, less talented people may choose to acquire a college education, even though it is more costly for them to do so. They would do so if the cost of acquiring education were less than the cost of sending the negative signal. If the bad type chooses to imitate the good type, the result would be a "pooling equilibrium"—namely,

46 Signaling costs in Spence's education model include not only the tuition costs, but also time, psychic costs, and other opportunity costs. *See* Spence, *supra* note 7, at 358–59.

47 *See id.* at 358.

48 *See id.* In Spence's job model, signaling costs are negatively correlated with productivity (i.e., the ability to learn), and thus are higher for the nonproductive type.

49 *See id.*

50 *See id.*

an equilibrium in which both types choose the same action and no signal is conveyed.

In particular, for a separating equilibrium to emerge and persist, the following conditions should be met. First, the bad type must find it profitable to avoid the signaling costs, even though this will expose its true type.[51] If this condition is not met, then both types might pool on the costly action. Second, the good type must find it profitable to signal its type despite the signaling costs.[52] If this condition is not met, then both types might pool on *not* taking the costly action. If both conditions are met, a separating equilibrium emerges, and the public can differentiates the good type from the bad type. The public can then replace the average discounted price with separate valuations for each type.[53]

2. Strict Governance as a Signal of Strong Market Descipline

Applying the signaling framework to this context, corporate governance choices could signal a firm's strong market discipline. To solve the adverse selection problem, management with little need for entrenchment should choose not to adopt staggered boards. In so doing, it signals its good type to the market. If a separating equilibrium occurs, the absence of a staggered board signals low private benefits,

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51 This condition is referred to as the bad type's "Incentive Compatibility Constraint."

52 This condition is referred to as the good type's "Participation Constraint."

53 Applications of Spence's signaling theory are abundant. *See, e.g.*, Merton H. Miller & Kevin Rock, *Dividend Policy Under Asymmetric Information*, 40 J. FIN. 1031, 1037 (1985) (constructing a model in which announcements of dividends signal high prospects from firms' projects); Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187, 188 (1984) (constructing a model in which a firm refusing to issue stock conveys a signal of low value); Eric A. Posner, *Symbols, Signals, and Social Norms in Politics and the Law*, 27 J. L. STUD. 765, 776 (1998) (developing a signaling theory that highlights cooperation).

while its presence signals insiders' interests in entrenchment and their extraction of high private benefits.[54]

Recall that the cost difference of performing the signaling action among the different types is critical for a signaling equilibrium to occur. This brings us to the next important point. The costs of choosing to commit to a strict legal regime are different for managers of different types. In particular, for an insider who extracts high private benefits, committing to a strict regime means that the insider would have to cut back significantly on these benefits. For insiders who extract only small private benefits, a strict regime that eliminates small benefits would be less costly.[55]

To illustrate, assume, for example, that Firm A faces significant competition in the product market and management runs the firm efficiently as a result. No alternative management could increase the firm's value by more than two percent. Firm B, however, faces weaker competition and, as a result, its management is less disciplined. Management replacement in Firm B could increase firm value by up to ten percent.

Firm B's management would clearly be more interested in a staggered board than Firm A's management would. Firm B's weak performance and low share value may lure hostile bidders who could profit by replacing its management. Thus, other things being equal, Firm B's management would be more inclined to adopt a staggered board.

54 *See* Michal Barzuza, *Lemon Signaling in Cross-Listing* 3–4 (Va. Law and Econ. Research Paper No. 2012-03, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1022282 (developing a model in which cross-listing on U.S. exchanges and bonding conveys a signal of strong discipline from market forces). Corporate governance might also signal information regarding firm value. *See* Lucian A. Bebchuk, *Asymmetric Information and the Choice of Corporate Governance Arrangements* 1 (John M. Olin Ctr. for Law, Econ., and Bus., Harvard Law Sch., Discussion Paper No. 398, 2002), *available at* http://ssrn.com/abstract=327842 (showing that when private benefits are correlated with firm value, lax governance signals high value); Edward M. Iacobucci, *Toward a Signaling Explanation of the Private Choice of Corporate Law*, 6 AM. L. & ECON. REV. 319, 320–21 (2004).

55 *See* Barzuza, *supra* note 54.

If both firms adopt a staggered board and investors cannot differentiate them, they will discount staggered board firms by 6%. Since Firm A's management desires a staggered board less, it may find the discount too large and refrain from adopting one. It may do so even though not adopting one slightly increases the likelihood of a hostile takeover. If Firm A's management abandons a staggered board, the price of a staggered board in the market would change and investors would discount the value of Firm B by 10% rather than 6%. In turn, Firm B might not find it worthwhile to maintain its staggered board, so it might drop it as well. If Firm B drops its staggered board, a pooling equilibrium would results in which no firm has a staggered board.

Put differently, as a result of differences in managers' interest in entrenching terms, and the benefits they can extract, a separating equilibrium could emerge where "good" firms—firms with low agency costs—choose strict law, while "bad" firms—firms with high agency costs—choose lax law, and investors discount the value of bad firms to reflect their type.[56] Furthermore, if the discount for adopting a staggered board is sufficiently large, a pooling equilibrium may emerge in which all types of managers choose strict law (for example, choosing to drop staggered boards).

Thus, signaling opportunities could improve the efficiency of firms' governance in two ways. First, if a separating equilibrium occurs, it will convey information to markets about the market discipline that management faces. Second, it will encourage some firms to adopt more strict and efficient governance terms.[57] Since the choice to adopt strict

[56] *See* Barzuza, *supra* note 54, at 6. Granted, lax law may cause harm to the company regardless of the firm type. As the next section demonstrates, the signaling effect will add a discount on top of that harm. (In Spence's model, the signaling effect distinct from the benefits of acquiring education is commonly referred to as the "sheepskin effect" because of the value of acquiring a diploma).

[57] Importantly, while in Spence's model such an outcome would be costly, this could be the most efficient outcome in the governance context. Signaling is costly. A pooling equilibrium in which everyone acquires

governance signals information about the power of market forces, the signaling effect could be significantly larger than the effect of a staggered board or majority voting term. In particular, assume as above that the value of a good firm (A) is one hundred (since its management faces strong discipline from the markets), and that the value of a bad firm (B) is fifty (since its management faces weak discipline from the markets). Lacking any information on the firm type, investors will value each firm at seventy-five. Since managers of good firms are less interested in entrenching terms, they could drop their staggered board and other entrenching terms, which would signal to the market that the firm's real value is one hundred rather than seventy-five.

III. NOISE ADOPTERS AND NOISY SIGNALS

A. Noise Adopters

Not all firms, and not all insiders, however, adopt corporate governance terms based on their preference for private benefits and the potential effect on the firm's share price. Some firms adopt corporate governance terms largely for reasons that have little or nothing to do with firm operations or strategy. For one, some firms follow the advice of their legal advisors regarding which corporate governance terms to adopt. For several reasons, this advice might depend on the identity of the advising law firm rather than the identity and needs of the adopting firm. First, law firms routinely work with boilerplates. A law firm may recommend the same corporate governance defaults to all of its clients, barring exceptional circumstances. Indeed, law firm identity has been shown to predict the design of merger

education in Spence's model is inefficient since it is both costly and does not convey any information (assuming, as Spence did, that studying has no value other than signaling value). What is unique to signaling in this context is that the costs are personal to the management, and while the governance terms impose costs on management, they also bestow benefits on the shareholders that are most likely higher than the costs to management.

contracts.[58] The boilerplate effect does not operate only at the individual firm level. Law firm geographical location was found to be a significant predictor of antitakeover defenses at the IPO stage: during the 1990s, corporations advised by West Coast law firms were significantly more likely to adopt antitakeover defenses in their IPO documents than firms that were advised by East Coast law firms.[59] Finally, boilerplates can operate on a smaller scale within law firms—for instance, a partner's identity was also found to explain variations in corporate contracts.[60]

Second, firms' initial governance decisions are made at the IPO stage. At this stage, adoption is even more likely to be idiosyncratic. The lawyers who prepare IPO documents specialize in going public and preparing SEC filings, but lack expertise about drafting governance terms about takeovers, voting, or compensation.[61] Organizational, time, and other practical constraints impede communication between departments that could mitigate random adoption.[62]

Third, law firms may have an inclination to recommend specific contractual terms. For example, local law firms tend to favor home state incorporation over incorporation in Delaware because such advice is self-serving: their knowledge, expertise, and competitive advantage favor state law.[63] Indeed, Delaware incorporations are commonly associated with the use of national law firms.[64]

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58 Christel Karsten, What Drives the Variation in Takeover Contracts: The Economics or the Lawyers? 3 (May 10, 2013) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2081805. *See also* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 755 (1997) (finding evidence that underwriters "significantly influenced firms' contracting choices").

59 *See* Coates IV, *supra* note 3, at 1304.

60 *See* Karsten, *supra* note 58, at 24.

61 *See* Coates IV, *supra* note 3, at 1314.

62 *See* MITU GULATI & ROBERT E. SCOTT, THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN 148–51 (2013).

63 *See* Daines, *supra* note 3, at 1584–86.

64 *See id.* at 1595.

In all of these examples, firms may adopt governance terms not because of their interest in a specific governance structure, but rather because of idiosyncratic factors such as the lawyers they choose. Additionally, inertia or the prevalence of the term influences a firm's corporate governance. First, changes in corporate governance terms are costly, as they may necessitate obtaining shareholder approval.[65] Second, corporate law and governance terms impose network externalities.[66] A term that is widely used has a value unrelated to its direct effect on the adopting company.[67] Therefore, a firm's decision to adopt particular corporate governance terms may be rationally affected by how many firms have already adopted that term.[68] Network externalities could explain why firms may adopt entrenching governance terms despite a term's substance and effect. If the term has been widely used, interpreted by courts, and incorporated into boilerplates then there is greater incentive to leave the terms as they are. In such instances, a firm may adopt a staggered board even if its management does not need it for entrenchment and does not intend to use it.

This Article uses the term "noise adopters" to describe firms adopting corporate governance terms for one or more of the foregoing reasons, for two reasons. First, their adoption of governance terms is idiosyncratic to some extent, as it does not depend fully on the content of the governance term. Second, as shown below, by adopting governance terms in this way, they diffuse noise into the market. Given the existence of noise adopters, investors cannot know for sure whether a firm adopted an entrenching term, such as a staggered board, because its management had a preference for entrenchment or rather because its law firm had the term as a boilerplate.

65 Reincorporation is accomplished via a statutory merger, which requires shareholder approval.

66 *See* Daines, *supra* note 3, at 1587.

67 *See id.* at 1584–87.

68 *See id.* at 1587.

B. Noise Adopters and Noisy Signals

The literature has widely recognized that firms may choose governance for the foregoing, non-substantive reasons. This section will show how noise adopters obscure the signals described above and, as a result, may affect pricing and adoption patterns of governance terms.

Recall the previous example, in which Firm A faces significant competition in the product market and thus is run efficiently. No other management could increase its value by more than two percent. Recall also that Firm B faces weaker competition and, as a result, its management is less disciplined. Alternative management could increase firm value by ten percent.

Firm B's management would clearly be more interested in a staggered board than Firm A's management would. Its weak performance and low share value may lure hostile bidders who could profit by replacing it with more effective management. Thus, other things being equal, Firm B's management is more inclined to adopt a staggered board.

Firms A and B also differ in the harm that a staggered board could cause. If Firm B does not have a staggered board, the threat of hostile takeover could discipline management to work harder or result in new management taking over. Both scenarios would result in higher shareholder value. If Firm B has a staggered board, however, shareholders may never realize this additional value. A staggered board, therefore, could result in a ten percent reduction of Firm B's value. For Firm A, on the other hand, no potential bidder could increase value significantly, since the firm is already approaching its full potential. A bidder could increase the firm's value by a maximum of two percent. Furthermore, a staggered board would not cause management to reduce its efforts or to extract more private benefits, since product market competition keeps management disciplined. Thus, the type of firm should matter to investors when pricing staggered boards. Investors should attach a larger discount to a staggered board in Firm B.

What would be the price of a staggered board in a market with only these two firms? As discussed *supra*, if both firms adopt a staggered board and investors cannot differentiate between them, they will discount both staggered board firms by 6%. Since Firm A's management desires a staggered board less than Firm B's management does, it may find the discount too large and refrain from adopting one. It may do so even though not adopting one increases the likelihood of a hostile takeover. If Firm A's management drops its staggered board, the price of a staggered board in the market would change and investors would discount the value of Firm B by 10% rather than 6%. In turn, Firm B might not find it worthwhile to keep its staggered board. If Firm B drops its staggered board, a pooling equilibrium results in which no firm has a staggered board.

Now assume that Firm C is a noise adopter. It adopted a staggered board only as a result of its law firm's boilerplate. Also assume that Firm C's type is unknown, but there is equal probability that it is similar to Firms A and B. In that case, the expected harm associated with a staggered board in Firm C is 6% (50% * 2% + 50% * 10% = 6%). Now, if Firm B and Firm C have staggered boards, investors will not attach a discount of 10% to the term anymore. Rather, they will attach an 8% discount—the average discounted price of Firms B and Firm C—to a staggered board.

As this example shows, noise adopters will reduce the discount that is attached to a staggered board. This, however, is not the end of the story. Now that the market discount of value due to a staggered board is lower, Firm B has stronger incentives to keep the staggered board. Furthermore, as firms like Firm B increasingly adopt staggered boards, such boards will become increasingly prevalent in law firm boilerplates, and thus it is more likely that other noise adopters will adopt them. This creates a feedback loop: the more noise adopters that adopt the term, the lower the discount, and the stronger the incentives to adopt it.

This example demonstrates that noise adopters could affect the discount that is attached to a corporate governance term—here, a staggered board—in the market and the incentives to adopt it. The following sections will develop a systematic analysis of the effects of noise adopters on the market.

C. Noisy Signals Encourage "Bad" Firms to Choose Protective Law

As the previous section suggested, noise adopters can affect the kind of equilibrium that emerges. In signaling equilibrium terms, noise adopters may influence whether a separating or a pooling equilibrium emerges and what kind of pooling (strict or lax law) firms will choose.

In particular, there are three main (but not unique) equilibria that could produce this setup: (1) a separating equilibrium in which good firms (firms that face significant market discipline) adopt strict governance and bad firms (firms that face weak market discipline) adopt lax governance; (2) a pooling equilibrium in which all firms adopt strict governance; or (3) a pooling equilibrium in which all firms adopt lax governance.

The decision whether to separate or pool involves trade-offs. For instance, if an insider who extracts high private benefits adopts a majority vote rule, he will lose his seat on the board if he continues to extract such benefits. On the other hand, the firm gets the benefit of avoiding detection as a "bad" firm by adopting the majority vote term that is usually associated with "good" firms. The equilibrium that emerges depends on the relative weight of these two factors, as well as other considerations, such as the market reward for being a "good" type.

If the discount from being identified as a "bad" type is large enough, insiders will adopt a majority vote rule even though they will be able to extract fewer private benefits of control. If, however, the signal is noisy and, therefore, weak, then the discount of sticking with plurality voting is weak as well.

Thus, due to the introduction of noise adopters, it is less likely that firms will pool on strict governance terms such as majority voting (or a non-classified board). Accordingly, it is more likely that a separating equilibrium will emerge in which many firms will retain plurality voting (or a staggered board). Furthermore, given the noisy signal and the partial discount from noise adopters, it is even possible that a pooling equilibrium on lax governance will emerge—that is, all firms will adopt weak governance (e.g., plurality voting, staggered board, home state of incorporation).

D. Noisy Signals Reduce the Incentives of "Good" Firms to Choose Good Law

A noisy signal also means that shares of the "good" firms receive a lower boost for revealing their type. If the market benefit of signaling is small, taking a costly signaling action might not be worthwhile. The noisy signal, and the resulting weak boost, may encourage a pooling equilibrium in the worst regimes.

Although noise adopters may lead to pooling in inefficient governance terms, the nature of the resulting governance terms depends on the context. In choosing a state of incorporation, for example, firms did not pool on their home states, where they get more protection. Rather, they separate between Delaware and their home states. Delaware, however, offers a number of other advantages. Incorporation in Delaware is valuable not only due to the positive signal it conveys, but also because of several other advantages that have been recognized in the literature, such as an exceptionally specialized and experienced judiciary, a developed body of case law, and an efficient administrative system. These advantages create additional incentives for the "good" type firms to move to Delaware.[69] Thus, it is less likely that all firms will choose to pool in their home state and in Nevada where they get lax governance.

[69] *See* Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 274–75 (1985). Granted, these advantages may also encourage the bad type to choose Delaware, yet they are likely to nonetheless be more valuable for the good type companies, who may benefit from a less efficient judicial system.

E. How Noise Adopters Change Equilibria's Likelihood

Table 1 summarizes the effects of noise adopters on potential market equilibria. In general, noise pushes in the direction of more entrenching governance. If, in the absence of noise, all firms pool into the best regime, then introducing noise adopters would tend to increase the likelihood that some firms opt for bad governance instead. Similarly, if, in the absence of noise, firms separate themselves between "bad" and "good" regimes, introducing noise adopters tends to increase the likelihood that all firms pool on entrenching governance.[70]

F. Information Bits and Updating Investors' Beliefs

The noise adopters theory can uniquely explain and predict the market's response to news. With noise adopters in the market, new bits of information (information that was previously obscured by the noise) could increase the probability of investors knowing that a specific firm is of a certain type. Accordingly, investors should update their beliefs and pricing to reflect such increased likelihood.

For example, consider a firm that is sued for awarding an outrageous compensation package to managers or for restating its earnings. These events would normally trigger a negative market response that reflects the loss of value resulting from the adverse event. But when such events happen to firms incorporated in their home state instead of in Delaware, or to firms that have staggered boards, the noise adopters theory predicts that the negative response might be stronger.

When a firm chooses to remain in its home state or to adopt a staggered board, investors are unsure whether the decision was motivated by malign or benign considerations. It could be that its managers were seeking entrenchment, but it could also be that its lawyers were locally-based or

[70] For a similar effect (though one not because of noise) see Bebchuk, note 54 (showing that if private benefits correlate with firm value, the desire to signal high value encourages firms to adopt lax governance).

worked with a boilerplate that included a staggered board. When such a firm also restates its earnings or is sued for awarding excessive compensation, investors may use this information as a signal of the firm type. The bad news causes investors to change their prior beliefs because it indicates that the firm is likely a "bad" type. The signal does not have to be clear and discrete. Rather, it is enough that investors will update their beliefs regarding the firm's type. The result would be a greater discount to the firm's share price. Sometimes investors may even intervene and try to force the firm to reincorporate outside of its home state.

G. What Explains Noise Adopters' Survival?

The emergence and survival of noise adopters is puzzling. Noise adopters could suffer discounts as a result of their governance terms. If they do not have particular interest in these terms, what explains the persistence of their behavior? This section proposes potential explanations, but this Article does not present a solution.[71]

If noise adopters' mass is significant, the discount that they suffer as a result of having a staggered board may not be significant. Indeed, a recent study found that, on average, staggered boards are not associated with a discount at the IPO stage (in contrast to the midstream stage).[72] Second, wide adoption imposes network and learning benefits regardless of the content of the term. Thus, these benefits could outweigh the impact of a signal that is already weak.[73] As a result, given a wide adoption of an entrenching term, it might be rational for noise adopters to keep it. Deviating to a less used, even if more efficient, term could actually result

71 Following Albert Kyle's seminal paper, substantial scholarship has attempted to explain the survival of noise traders. *See* J. Bradford De Long, Andrei Shleifer, Lawrence H. Summers & Robert J. Waldmann, *The Survival of Noise Traders in Financial Markets*, 64 J. BUS. 1 (1991).

72 *See* William C. Johnson, Jonathan M. Karpoff & Sangho Yi, The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms 33 (Apr. 23, 2013) (unpublished manuscript), *available at* http://papers.ssrn.com/abstract=1923667.

73 *See* Daines, *supra* note 3, at 1587.

in a discount. Finally, it is possible that agency costs on the professionals' side incentivize noise adopters to adopt inefficient terms. For example, as explained above, local law firms may advise firms to incorporate in their home state, where that law firm has a competitive advantage, even if incorporating in Delaware would be a better choice.[74] If the company does not seek the advice of a national law firm, it may not be aware of the full implications of incorporation in its home state instead of in Delaware.

IV. EXPLAINING PUZZLES AND RECONCILING EVIDENCE

A. Explaining the IPO vs. Midstream Puzzle

An important distinction emerged in classic theory regarding the efficiency of adopting corporate governance terms at the IPO stage and at the midstream stage (after the firm's shares have been publicly traded). In the midstream stage, insiders typically hold a small fraction of the company shares. Thus, their incentives are less aligned with those of shareholders and the agency costs problem is more apparent. Shareholders are rationally ignorant and infused with collective action problems. Thus, we expect firms' midstream corporate governance decisions to be more favorable to management. The IPO stage, however, is different. At this stage, when the founder takes the firm public, he internalizes the consequences of his choices via the price that investors are willing to pay for his shares. Rather than adopting entrenching terms, the founder is expected to adopt only efficient terms whose benefits to shareholders outweigh their costs.[75]

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[74] *See* Daines, *supra* note 3, at 1566; Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 386 (2003).

[75] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 312–13 (1976) (formalizing and developing the insight that

To illustrate, assume that a manager derives private benefits equal to 100 from having a staggered board. Also assume that a staggered board imposes inefficiency costs of 1000 on shareholders. Under these circumstances, a staggered board is clearly inefficient and should not be adopted. In the midstream stage, however, if the manager holds, for example, only 2% of the firm's shares, the manager will want a staggered board. This is because the manager's private benefit remains 100 and his private cost is only 20 (as a 2% shareholder). In fact, as long as the manager holds less than 10% of the company shares, he will want to implement an inefficient staggered board. The manager's private cost-benefit analysis at the IPO stage is fundamentally different. At the IPO stage, if the founder sells 98% of his shares, implementing a staggered board means he will have to reduce the price for the shares he sells to 980. Thus, in this case, his personal cost of implementing a staggered board amounts to 1000 and—not surprisingly—outweighs his potential private benefits from having a staggered board. To be sure, the IPO stage does not always correspond to this extreme paradigm.[76] Capital markets are not perfectly efficient and do not always price terms correctly. Founders may have agency problems among them.[77] Yet, relative to the midstream stage, one would expect the IPO stage to be less affected by agency problems. The classic theory has a simple prediction: if staggered boards are not efficient at the IPO stage, companies should adopt them at a lower rate at the IPO stage, if at all, than at the midstream stage.

When evidence was finally collected about these terms, however, it did not directly correspond to the theoretical analysis. Contrary to theoretical predictions, staggered boards were significantly more likely to be adopted at the

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founders will adopt only efficient terms whose benefits to shareholders outweigh their costs).

76 *See* Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 110 (2001).

77 *See id.*

IPO stage than midstream.[78] In the midstream stage, it became almost impossible to adopt a staggered board.[79] Institutional investors routinely voted against staggered boards.[80] Proxy advisory companies recommended voting against a staggered board proposal, and many firms were forced to declassify their boards.[81] On the other hand, at the IPO stage, the majority of firms adopted staggered boards.[82] For example, thirty-nine of fifty U.S. firms undertaking an IPO from January 2009 through August 2011 had a staggered board.[83]

Patterns regarding home state incorporation exhibit similarly puzzling behavior. At the IPO stage, 32.7% of 6,530 firms surveyed chose to incorporate in their home state, where they either already had or could lobby for legal protection.[84] Investors and market intermediaries largely accept home state incorporation choices at the IPO stage. Similar choices at the midstream stage, however, are much more difficult to effectuate. Recently, for example, the management of Abercrombie & Fitch scheduled a shareholder meeting to vote on reincorporating in Ohio, the company's home state.[85] Following bad publicity, adverse views from proxy advisory companies, and shareholder resistance, the meeting was postponed.[86]

78 *See* Daines & Klausner, *supra* note 76, at 110.

79 See Klausner, supra note 9, at 758–59.

80 *See id.*

81 *See* SHAREHOLDER RIGHTS PROJECT, THE SHAREHOLDER RIGHTS PROJECT 2012 REPORT 1–2 (2013), *available at* http://srp.law.harvard.edu/releases/SRP-2012-Annual-Report.pdf.

82 *See* Klausner, *supra* note 9, at 763.

83 *See* DAVIS POLK & WARDWELL LLP, CORPORATE GOVERNANCE PRACTICES OF U.S. INITIAL PUBLIC OFFERINGS (EXCLUDING CONTROLLED COMPANIES) 5 (2011) [hereinafter DAVIS POLK IPO REPORT], *available at* http://www.davispolk.com/files/uploads/CapitalMarkets//103111_CorpGov Practices_Booklet__Controlled_Excluded.pdf.

84 *See* Bebchuk & Cohen, *supra* note 74, at 394, 398–99; Daines, *supra* note 3, at 1578–82 (discussing how regulatory benefits to local firms may explain the home state bias).

85 *See* Davidoff, *supra* note 11.

86 *See id.*

Finally, a mirror puzzle exists with respect to majority voting terms that firms have moved to adopt in the midstream stage. By 2011, 79% of S&P 500 companies had majority voting terms.[87] Yet almost none of the new IPOs adopted majority voting as part of their IPO package.[88]

The noisy signal theory is consistent with, and helps to resolve, this ostensibly contradictory body of evidence. Boilerplates are prevalent at the IPO stage and, as a result, automatic adoption of governance terms such as staggered boards is not uncommon.[89] IPO boilerplating can be explained in a variety of ways. IPO departments at law firms have no particular background in firm governance terms such as takeover defenses.[90] Even if a firm has both an M&A and IPO practice, the two departments do not necessarily communicate frequently.[91] Finally, IPO pricing does not seem to be significantly influenced by the governance terms adopted.[92]. Thus, unless it is particularly interested in entrenchment, management may be too preoccupied to focus on the type of governance it plans to adopt. If management is not particularly interested in entrenchment, the kind of governance it adopts is not a top priority.

87 *See* Richard Sandler & Elizabeth Weinstein, *A Spotlight on Shareholder Proposals: Majority Voting*, DAVIS POLK BRIEFING: GOVERNANCE (Jul. 13, 2012), http://www.davispolk.com/briefing/corporategovernance/61647/.

88 *See* DAVIS POLK IPO REPORT, *supra* note 83, at 9 ("Of the 50 companies examined, 47 companies (94%) required a plurality standard for board elections.").

89 *See* Coates IV, *supra* note 3, at 1320 (explaining that boilerplates provide a source of information regarding which takeover defenses to adopt).

90 *See id.* at 1314 (explaining that the legal market is segmented such that lawyers who specialize in takeovers are not experienced in IPOs and vice versa).

91 *See id.* at 1319 n.78 (describing the reasons that communication is lacking between IPO and M&A attorneys at the same firm).

92 *See id.* at 1381.

Conversely, in order to implement a staggered board in the midstream stage, managers must seek it proactively.[93] First, the board must vote on a resolution to adopt a staggered board.[94] Next, the board must seek shareholder approval of the resolution[95] and the proxy materials must explain why the company is seeking a staggered board.[96] As the board needs to vote on the term separately and proactively seek shareholder approval, it is less likely that the adoption is innocuous. Rather, it is more likely that the board is attempting to strengthen entrenchment.

B. Evidence on How Investors Update Their Beliefs

The noisy signal hypothesis helps explain how investors respond to news. For example, when firms incorporate in Nevada (a state with extremely lax corporate law), empirical evidence suggests that there is no significant discount attached.[97] Yet, when firms restate in Nevada, the penalty is significantly higher than the one accompanying financial restatements in Delaware.[98] Why do investors not penalize firms that incorporate in Nevada, but penalize them more heavily when they restate? The noise adopters theory is consistent with and helps to explain this evidence.

Under the noise adopters theory, when firms incorporate in Nevada, investors do not know the reason for this choice. It could be that management was interested in significantly entrenching rules or that management was lured by Nevada's lower taxes. Alternatively, the company's lawyers may have effectively made the choice. Thus, the signal of incorporating in Nevada is noisy. In contrast, when firms

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93 *See* DEL. CODE ANN. tit. 8, § 141(d) (2013).

94 *See id.*

95 *See id.*

96 *See* 17 C.F.R. § 240.14a-101 Item 19 (2013).

97 *See* Barzuza & Smith, *supra* note 12, at 5 ("[U]sing Tobin's Q regressions . . . we find that the value of Nevada firms is statistically indistinguishable from [those of] the average state . . . .").

98 *See id.* at 6 (illustrating that firms incorporated in Nevada, as compared to restating firms in other states, have a greater decline in value the year following their restatement).

restate their financials, it conveys a stronger signal regarding the type of firm that incorporates in Nevada. In particular, investors update their beliefs regarding the probability that the firm is a bad firm that chose to incorporate in Nevada for malign reasons.

At times, bad signals may even cause investors to become active in order to change the governance initially adopted. For instance, the shareholder proposal to reincorporate Chesapeake Energy from Oklahoma to Delaware, which received support from fifty-three percent of the votes cast, followed troubling revelations regarding Chesapeake's management. Explaining why he submitted a proposal to reincorporate to Delaware, shareholder Gerald Armstrong said: "Something is out of balance here at Chesapeake."[99] The move, he suggested, would bring greater accountability to the company.[100] Reincorporation proposals are not common. In the absence of red flags, for most firms, the assumption remains that they may have chosen the home state for other reasons.

V. IMPLICATIONS

A. Consequences for ECMH Theory and Contractual Freedom in Corporate Law

Firms do not pay the full price for choosing a legal regime that protects management. Thus, this Article proposes a qualified version of the ECMH as applied to corporate governance. Under the noise adopters approach, governance terms are publicly known, but *why* these firms adopted those terms—which is relevant for evaluating their value—is unknown. Noise adopters obscure the motivation. As a result, market prices do not necessarily reflect the true value of corporate governance rules and terms when applied to a specific firm.

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99 *See* Tim Talley, *Chesapeake Investors up in Arms: Two Directors Resign as Shareholders Rebuke the Board at the Annual Meeting*, TULSA WORLD, June 9, 2012, at E1.

100 *See id.*

Accordingly, policy analysis of contractual freedom in corporate law should account for the existence of noise adopters. Since noise adopters obscure a signal that would otherwise be associated with entrenching terms, managers do not fully internalize the costs of these terms. Managers with an interest in entrenchment do not pay the full ticket price for their preference or for the harm that it causes the company. The results could vary from a majority of firms adopting entrenching terms to all firms adopting them. Due to asymmetric information and noise adopters, the decision whether to adopt governance terms is more complicated than previously thought. Moreover, this generates sub-optimal outcomes, as it may incentivize the adoption of entrenching terms.

This analysis does not necessarily suggest, however, that mandatory law should regulate governance terms. As proponents of contractual freedom argue, regulation of governance terms has its costs. Firms may know better which terms are most suitable; one size does not fit all. Additionally, legislators may not know which governance terms maximize value.[101] This analysis suggests, however, that we should move away from the automatic assumption that governance terms are efficient just because firms have adopted them voluntarily.

This analysis also casts doubt on the assumption that the IPO stage is superior to the midstream stage in terms of the choice of governance terms. With respect to the choice of governance terms, such as the state of incorporation and board classification, shareholders may have better insight into the reasons behind the adoption of a term at the midstream stage—insight that they often lack at the IPO stage. Put differently, while the midstream stage suffers more from agency costs, it provides better information symmetry.

101 *See* Easterbrook & Fischel, *supra* note 1, at 1432.

B. Consequences for Disclosure Obligations

Firms disclose their governance structure, but, as this analysis suggests, investors need additional firm-specific information in order to accurately assess firm value. Under some circumstances, firms are also required to disclose their motives for adoption of governance terms, such as when they seek shareholder approval to adopt a staggered board or reincorporate to another state.[102] Yet firms have not been completely transparent in disclosing their motives for adopting or changing governance terms. For example, when firms initiate reincorporation from Delaware to another state—typically their home state—they tend to use vague language to describe their motivations. Companies say that the new state provides "a clearer balance of corporate governance rights and obligations than Delaware law,"[103] a better "ability to attract and retain highly qualified individuals to serve as directors,"[104] or "increased flexibility,"[105] even though their real motives are often more specific. When Abercrombie sought approval to reincorporate from Delaware to its home state of Ohio—a state notable for its strong legal protections against acquisitions—its proxy materials referred only vaguely to an anti-takeover motivation.[106]

Recently, however, the SEC has been paying attention to this issue. In a 2013 release, SEC Commissioner Luis A.

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[102] *See* 17 C.F.R. § 240.14a-101 Item 19 (2013).

[103] *See* Steven M. Davidoff, *Abercrombie's Ohio Express*, N.Y. TIMES DEALBOOK (Dec. 23, 2010, 4:06 PM), http://dealbook.nytimes.com/2010/12/23/abercrombies-ohio-express/.

[104] *See id.*

[105] *See* Barzuza, *supra* note 21, at 984.

[106] *See* Davidoff, *supra* note 103 (Regarding its motivation, Abercrombie explained that "reincorporating into Ohio would provide the company with an opportunity to address a number of corporate governance matters in a manner that we believe appropriately protects and benefits the company and its stakeholders."). Additionally, Davidoff notes that Abercrombie filed its intention to reincorporate in late December, "the time of year when news is announced in the hope that no one will notice." *Id.*

Aguilar urged companies to better disclose the reasons for not separating the board chairman and firm CEO positions, as required under Item 407(h) of Regulation S-K.[107] Item 407(h) requires that disclosures indicate why the registrant has determined that its leadership structure is appropriate "given the specific characteristics or circumstances of the registrant."[108] The commissioner noted that such analysis is often missing. Stating that "[i]nvestors deserve better than mere boilerplate," the commissioner explained that the commonly provided "efficiency" or "depth of knowledge" justifications are insufficient.[109] Rather, every board should explain why the governance it has adopted is best suited to the company.[110] Indeed this Article suggests that a robust enforcement of these requirements could contribute to the efficiency of capital markets and governance terms.

VI. CONCLUSION

This Article fills a gap in the corporate governance literature by identifying and analyzing noise adopters' influence on corporate governance. It shows that noise adopters may affect the pricing and patterns of adoption of corporate governance terms.

The arbitrary choice of governance terms by noise adopters allows management with weak market discipline and strong interest in entrenchment to camouflage its deliberate choice. Noise adopters mitigate the discount attached to entrenching terms and increase the likelihood that others adopt such terms. Since the tendency to adopt governance terms without close attention to detail is especially high at the IPO stage, this period is particularly

107 *See* Luis A. Aguilar, Comm'r, SEC, Shareholders Need Robust Disclosure to Exercise Their Voting Rights as Investors and Owners (Feb. 20, 2013), http://www.sec.gov/news/speech/2013/spch022013laa.htm#P38_11590.

108 *See* 17 C.F.R. § 229.407(h) (2013).

109 *See* Aguilar, *supra* note 107.

110 *See id.*

vulnerable to camouflage. This Article suggests that governance choice at the IPO stage may be less efficient than the adoption of governance terms midstream. Noise adopters theory contains implications for the way investors respond to news about governance changes. This Article shows that these responses could be influenced by the firm's pre-existing governance structure. Finally, this Article explores potential explanations for the puzzling survivorship of noise adopters such as positive network externalities and agency costs in legal services.