ECGI

Law Working Paper Series

Working Paper No. 50/2005

Yale Law School

Center for Law, Economics and Public Policy

Research Paper No. 323

After the Revolution in Corporate Law

Roberta Romano

October 2005

This paper can be downloaded without charge from the
Social Science Research Network Electronic Paper Collection at:
http://ssrn.com/abstract=824050

european corporate governance institute

ecgi

After the Revolution in Corporate Law

Law Working Paper N°.50/2005

October 2005

Roberta Romano
Yale Law School, NBER and ECGI

© Roberta Romano 2005. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

This paper can be downloaded without charge from:
http://ssrn.com/abstract=824050.

www.ecgi.org/wp

european corporate governance institute

ECGI Working Paper Series in Law

After the Revolution in Corporate Law

Working Paper N°.50/2005
October 2005

Roberta Romano

This paper is based on the Oscar M. Ruebhausen Inaugural Lecture given at Yale Law School on September 21, 2005.

©Roberta Romano 2005. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

Abstract

Corporate law is a field that underwent as thorough a revolution in the 1980s as can be imagined, in scholarship and practice, methodological and organizational, in which finance and the economic theory of the firm were used to inform the field. The timing of this revolution was not a fortuitous occurrence: it followed a revolution in corporate finance and the theory of the firm, and was mid-wived in a period of dynamic innovation in corporate transactions. The transformation in corporate law scholarship and practice accomplished by this revolution, has important implications for legal education in the 21st century. There is a need for greater integration of law school and management school curriculums, to ensure that law school graduates will obtain the technical proficiency necessary to be at the leading edge of corporate law practice and scholarship. In addition, the sea change in corporate law scholarship places law schools with larger faculties and associated with universities with strong finance groups at a competitive advantage in recruiting business law faculty and in maintaining a first rate business law program. Corporate law centers have emerged as an institutional device for smaller elite schools to adapt to this new environment.

Keywords: corporate law, legal education, corporate law centers

JEL Classifications: K22, K00

Roberta Romano
Yale Law School
P.O. Box 208215
New Haven, CT 06520-8215
United States
phone: 203-432-4965 , fax: 203-432-4871
e-mail: roberta.romano@yale.edu

Corporate law is a field that underwent as thorough a revolution in the 1980s as can be imagined, in scholarship and practice, methodological and organizational. The term revolution is invoked all too often in popular culture, but as this paper will suggest, it is entirely apt in this case. For the revolution in corporate law has been so thorough and profound that those studying in the field today would have difficulty recognizing what it was like 25 to 30 years ago. I was fortunate to have started out in law teaching in that turbulent, transitional era, for it was an exciting time to be in corporate law.

This revolution has produced one of the more, if not the most, interdisciplinary fields of law. One measure of the transformation of the field is that the submissions to the annual meeting of the American Law and Economics Association, which now number in the 100's, are overwhelmingly dominated by corporate law scholars; they could fill up most of the program, were the Association not to limit the number of corporate-law-related sessions to encourage broader program coverage and participation. The integration of finance and economic theory into legal analysis is true not solely of corporate law scholarship but has been pervasive, extending to practice and judicial decisionmaking.

The first part of this paper sets out why the revolution experienced in corporate law in the 1980s was not a fortuitous occurrence: it followed a revolution in corporate finance and the theory of the firm, and was mid-wived in a period of dynamic innovation in corporate transactions. The paper will thereafter touch briefly on the course of the revolution, and how it reached all aspects of corporate law - from practitioners to academics, to regulatory agencies and U.S. and State Supreme Court opinions. It concludes by discussing the implications of the sea change in corporate law scholarship and practice for legal education in the 21st century. I believe that the developments that we have witnessed in the field over the past 20 years have important

implications for the shape of legal education.

Corporate Law Before the Revolution

In the 1960s, corporate law was an ossified, stagnant field. Dean Bayless Manning aptly summed up the situation in 1962 as follows: "Corporation law, as a field of intellectual effort, is dead in the United States... We have nothing left but our great empty corporation statutes - towering skyscrapers of rusted girders, internally welded together and containing nothing but wind."[1] Most state corporation codes at the time were relics of the turn of the previous century; Delaware was to modernize its code in 1967, and the first revision of the Model Business Corporation Act was completed in 1969. The state of corporate law scholarship was not much different from that of corporation statutes.

We can trace the intellectual origin of what would become the new paradigm for corporate law to a pioneering article on mergers published only a few years after Manning's comment in 1965 by Henry Manne.[2] The article coined the term "the market for corporate control," challenging the conventional view of mergers as anticompetitive by contending that control changes in mergers played an efficiency-enhancing role replacing poorly performing managers and that the takeover mechanism was preferable because it avoided management's transactional veto, which was required by merger statutes. But that article appeared in the Journal of Political Economy (a leading economics journal) and not in a law review, and

[1] Bayless Manning, The Shareholders' Appraisal Remedy: An Essay for Frank Coker, 72 Yale. L. J. 223, 245 n.37 (1962). William Carney also summarizes the state of the field as having reached an intellectual dead-end in a tribute to Henry Manne, in William Carney, The Legacy of the "Market for Corporate Control" and the Origins of the Theory of the Firm, 50 Case Western Res. L. Rev. 215, 221-225 (1999).

[2] Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110 (1965).

Manne's important contribution went largely unrecognized in corporate law scholarship for close to two decades.

Manne's contributions to corporate law were numerous, as he produced a series of highly original articles covering shareholder voting and litigation, among other governance topics. While these articles were published in law reviews, paralleling the reception of his mergers article, none of his ideas had significant influence on the legal literature until years later. Moreover, when Manne's writings did catch the attention of legal academics of his day it worked to his detriment. His provocative work advocating the efficacy of insider trading as a form of managerial compensation was no doubt one reason why Manne was never to receive an appointment on one of the leading law school faculties, as many of his contemporaries thought that to advocate such a position he had to have been "ethically challenged."[3] Although this must be one of the most egregious appointment oversights of a generation, and a sad commentary on the law schools of the time, standing as a cautionary tale against intellectual narrowmindedness, ironically it provided a major benefit to legal scholarship and the profession. Manne became a highly successful academic entrepreneur, introducing generations of lawyers and judges to economics and economists to law, through the law and economics institutes he administered at several institutions, concluding with the deanship of George Mason University's law school. He was also honored by the American Law and Economics Association, along with Guido Calabresi, Ronald Coase and Richard Posner, with a lifetime membership as a founder of the economic analysis of law.

---

[3]For Manne's description of his experience see Henry G. Manne, How Law and Economics Was Marketed in a Hostile World: A Very Personal History, in Francesco Parisi & Charles K. Rowley, eds., The Origins of Law and Economics: Essays by the Founding Fathers 309, 311-12 (Northampton, MA: Edward Elgar, 2005).

To return to my theme of the revolution in corporate law, as I've already noted, there was nearly a 20-year lag in the acknowledgment of the significance of Manne's contributions, and this was not fortuitous. The perspective of legal scholars on corporate law in the 1960s and 70s differed dramatically from our contemporary understanding: as Judge Ralph Winter has described it, corporate law back in those days was treated as a "species of consumer protection law," based on the perception that managers ran corporations with the objective, under the aegis of state corporate law, of exploiting shareholders, and that neither the states nor markets could be trusted to constrain managers or otherwise protect investors.[4] In line with this view, 80 law professors (which would appear to have been the decisive majority of corporate law specialists) signed a petition in 1976 advocating Congress' adoption of a national corporation law to preempt the states.

But a year later, that view was challenged by Winter, in a 1977 article, which identified fundamental analytical flaws in the conventional understanding, embodied in the law professors' petition, of state law as a 'race for the bottom" that facilitated managers' exploitation of shareholders.[5] The article contended that managers would not select legal regimes that systematically disadvantaged investors because that would raise their cost of capital compared to competitors located in regimes more favorable to investors, and consequently diminish their career prospects (they risked being fired as their firms would eventually go bankrupt or be acquired given the higher capital cost). Paralleling Henry Manne's article on mergers, Winter's

---

[4] Winter, Foreword to Roberta Romano, The Genius of American Corporate Law ix (Washington, D.C.: AEI Press, 1993). See also Carney, supra note 2.

[5] Ralph K. Winter, State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Leg. Stud. 251 (1977).

economic analysis of the production of state corporate law went against the grain of the consensus understanding and Winter's article was therefore also largely ignored by the academy. Winter and Manne were truly voices in the wilderness and their analyses were widely regarded as "unsound" by their contemporaries. Today, decades later, their approach is mainstream corporate law, and serves as a starting point of present-day analyses of both advocates and critics of mergers and acquisitions and of state corporate law.

This transformation of the discourse is part and parcel of a revolution that effected a paradigm shift in how we understand corporations, business transactions, and the legal rules governing them, that took place in the decades following Manne's and Winter's publications. Manne and Winter were not any less skillful analysts or policy advocates than the generation of scholars that followed. Rather, the methodology that would have enabled Manne and Winter to compel their contemporaries to confront (if not accept) their analyses by enabling them to demonstrate that their hypotheses regarding how managers behaved and how acquisitions and the market for control worked to discipline managers were correct, was not in place when those articles were written. It was only just being developed and therefore it was only some time later when their hypotheses could be tested and their insights fully appreciated; the impetus for their contemporaries to update their prior beliefs concerning regulation was lacking. Furthermore, the new transactions that underscored the intellectual vacuousness of the then dominant doctrinal paradigm did not yet exist. That is when the revolution, to which I will now turn, took hold.

The Revolution

There are three distinct strands to the story of the transformation of corporate law in the latter half of the 20th century. An important milestone in the making of the revolution in corporate law was the pioneering casebook on Corporate Finance, by Victor Brudney and

Marvin Chirelstein.[6] Their casebook was pathbreaking for it introduced a new methodology, modern finance, into the business law curriculum.

Chirelstein had been dragooned by Dean Eugene Rostow into teaching what was then called Business Units II when he arrived at Yale Law School in 1965 from Rutgers, where he and Brudney had been colleagues. What was there to do with a course that consisted "entirely of case-annotations for commonly used bond indentures and other boiler-plate documents," and was "the most boring and insignificant course ever offered anywhere at any time in any language"(as Chirelstein put it)? Well, the 1960's were a fervent period in the theoretical development of finance, which had previously been an unexciting, descriptive field involving financial ratio analysis and rules of thumb. Finance had been as dead a field as Manning's depiction of corporate law, but no longer. Reading the Journal of Finance in those days was certainly more intellectually stimulating than reading the dreary provisions in bond indentures, and Chirelstein thought that was just the thing to spice up Business Unit II's stolid cases that were the source of those indenture provisions.

That is, there was a veritable intellectual revolution bubbling up in finance in the 1960s and that left an impression on Brudney and Chirelstein. They were intrigued by the notions of random walk, and efficient markets, buzzing around in the air at the time, and what impact these concepts would have on the liability and property rules relating to corporate law. They put these ideas together into a casebook that was published in 1972. The casebook could not, however, have appeared much earlier because of the relative infancy of the tools of modern finance. A brief chronology of the theoretical breakthroughs in finance conveys the point:

---

[6] Victor Brudney & Marvin A. Chirelstein, Cases and Materials on Corporate Finance (Mineola, NY: Foundation Press, 1972).

- In 1952, modern financial theory was born with the publication of Harry Markowitz's dissertation, which developed what is referred to as the portfolio theory of investment decisionmaking, or portfolio selection, introducing a security's risk, as well as its return, into the decisional mix.

- Shortly after Markowitz' dissertation, in two important articles published in 1958 and 1962, Franco Modigliani and Merton Miller, referred to in the literature as "M & M," developed irrelevance theories of firm capital structure and valuation launching a debate that continues to this day.

-The next milestone was in 1964-65, with the specification of the capital asset pricing model, better known in the literature as the CAPM, a model for measuring risk, independently developed by John Lintner and William Sharpe.[7] This was an important development because it made Markowitz's portfolio theory more tractable -- one could solve for the optimal portfolio without complex computer programming -- and it put the theory into an empirically testable form, which is critical for a theory's acceptability. In 1990, Markowitz, Miller and Sharpe shared the Nobel prize in economics (Modigliani had won a Nobel prize years earlier.) With that award, we can say that finance had arrived. The relative recency of the award, indicating acceptance of finance's contribution to economics, is a further reminder of how trail-blazing the Brudney and Chirelstein casebook was, in its taking an "infant" discipline as the mode of analyzing the key concerns of corporate law.

---

[7] Jack Treynor also independently discovered the CAPM in a paper written in 1962, but that work was not recognized as such until many years after the publications by Sharpe and Lintner; even Treynor did not recognize the importance of the insight in his paper at the time it was written. See, e.g., Perry Mehrling, Fischer Black and the Revolutionary Idea of Finance 59, 73 (Hoboken, NJ: John Wiley & Sons, Inc. 2005).

To return to the reason why the CAPM was an important step in the progress of finance theory, its testability, it should be noted that a major component of finance research consists of testing the accuracy of pricing models.[8] In this regard, finance differs from many other fields in economics with its decidedly empirical focus; after all, financial economists very much want to know if by developing a new pricing model or implementing a particular trading strategy they can make money. The most important empirical finance methodology for policy purposes consists of what the literature refers to as event studies, which measure the effect of specified "events" on stock prices.

Event studies were developed in conjunction with testing the concept of an efficient market, the idea that market prices incorporate information; in an efficient market, abnormal profits cannot be made by trading on public information. The modern literature on efficient markets dates from an article by Paul Samuelson published in 1965 and reached a broad audience with the publication of Eugene Fama's classic survey in 1970.[9] The first modern event studies were published by accountants in 1968 and by financial economists in 1969; this constitutes the final finance innovation of relevance to the revolution in corporate law. Event studies, which are now a large cottage industry, literally 100s having been published in nearly all finance journals, provided a methodology for testing Manne's and Winter's hypotheses regarding the market for control and corporate charters. In that regard their development was as

---

[8] In a well-known critique of the testability of the CAPM, Richard Roll emphasized that the market portfolio is unobservable and hence tests are of the mean-variance efficiency of a proxy and not the true market portfolio, but subsequent empirical and theoretical work has indicated that his concern is not a problem in practice. See John Y. Campbell et al., The Econometrics of Financial Markets 213-15 (Princeton, NJ: Princeton Univ. Press, 1997).

[9] John Campbell, Andrew Lo and Craig MacKinlay sketch the modern development of the efficient market hypothesis and the event study methodology in id. at 20, 150.

critical a component in the revolution in corporate law as that of the finance theory they were testing, and they have had an important impact on the course of corporate law and corporate governance. The application of the technique did not really take off in academia, however, until the burst of takeover activity in the 1980s.

In a nutshell, then, the major breakthroughs in modern finance were still quite recent and were not fully assimilated in the finance profession when the Brudney and Chirelstein casebook was published and began the effort to connect the learning of modern finance with business law. The effort, in short, simply could not have begun much earlier. It should also be evident that the intellectual roots of modern corporate law scholarship are quite distinct from the standard microeconomic methodology applied in the law and economics literature. This is an important distinction to which I will return when considering the implications of the revolution for legal education and scholarship.

Paralleling the intellectual revolution that occurred in modern finance in the 1960s, a similar revolution was occurring in economics regarding the theory of the firm in the mid-1970s. This is the second strand contributing to the revolution in corporate law. In the mid-1970s, there was an attempt by a number of economists to delve inside the black box of the firm as it was characterized in neo-classical economics (the firm as a production function), and to understand it on a micro-analytic level. I'll note two basic lines of development in this research agenda that have had a lasting impact on the thinking of corporate law academics. First, transaction cost economics. This research is associated most closely with Oliver Williamson, whose foundational book on business organization, Markets and Hierarchies was published in 1975 (this line of research works out of a now-celebrated article that was all but ignored for decades, Ronald Coase's 1932 article on the Nature of the Firm, for which, along with his article on Social Costs,

he received the Nobel prize in economics in 1991).[10] Second, the agency costs theory of the firm. This line of research was introduced in 1976 by Michael Jensen and William Meckling, who, working from the corporate finance literature, gave systematic economic content to the much earlier key observation of Adolf Berle and Gardiner Means in 1932, that ownership was separated from control in the modern US corporation.[11] Both of these theoretical approaches for analyzing firms were mathematicized and refined by economists in the decades to follow and the microanalytic approach to the firm has come to permeate the microeconomics and industrial organization literature.

The third critical strand that, when conjoined with the analytical tools of modern finance and the new theory of the firm, produced a full blown revolution, came from the world of corporate practice: an explosion in innovative deals. At the time when the new theoretical developments in finance were rapidly being integrated into the business school curriculum, there was a boom in acquisitive transactions of public corporations and a new dynamic in control changes emerged. This was to be the era of the hostile takeover, undertaken through a novel, highly-leveraged structure, made possible by innovations in transaction financing developed by Michael Milken and his investment bank, Drexel Burnham and Lambert. Milken's reinvention of junk bonds as a financing mechanism for new ventures, and his support of a market for the new issues that he placed, enabled small firms to acquire large ones previously considered impervious to unsolicited bids, and changed the way business was conducted in the United

[10] Oliver E. Williamson, Markets and Hierarchies: Analysis and Antitrust Implications (New York: Free Press, 1975).

[11] Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. Fin. Econ. 305 (1976).

States. The use of such financing for hostile takeovers was in fact a relatively small segment of the high-yield market created by Milken, although no doubt the most visible part; the instruments provided relatively inexpensive financing for many small and mid-sized firms in what were then new and underdeveloped sectors of the economy - providers of cellular phones, cable television, and personal computers, among others.[12] Before Milken's new issue operation, the junk bond market consisted principally of downgraded debt of established firms.

The new financing techniques catapulted Drexel, which had been a sleepy investment bank into a prominent and highly profitable one (although the firm disappeared after the SEC filed civil charges against it and Milken for securities fraud and it pled guilty to criminal charges, those techniques survived the firm and became ubiquitous). There was also a parallel rapid growth in law firms specializing in mergers and acquisitions transactions, working on the hostile bidder side as well as on the defense.

More importantly, lawyers and courts needed new ways to talk and think about these novel transactions and how to respond (for example, what should be the fiduciary standard for the actions of managers and boards of directors in response to a hostile bid? how should the fairness of the price in a negotiated or hostile acquisition, be evaluated? should shareholder consent to actions that could be used to thwart takeovers be discounted because that consent had been granted before takeovers had become common and those actions took on a defensive use? more concretely, how could an effective defense be structured while preserving flexibility to entertain alternative bids, and so forth.) The theoretical developments in finance and in the theory of the firm literature provided the language and the analytical tools to address a host of

[12] See, e.g., Glenn Yago, Junk Bonds: How High Yield Securities Restructured Corporate America (New York: Oxford Univ. Press, 1991).

challenging novel legal issues.

As the decade progressed and deals continued apace with the transaction scale ever-increasing, the profitability of mergers and acquisitions practice correspondingly increased, attracting the attention of more established investment banks and law firms. As the old line firms entered the takeover business, the nature of business law practice, came to be fundamentally reconfigured. Since the best academic scholarship in corporate law is in a symbiotic relation with real world transactions, it followed suit.

Namely, modern finance introduced into the law school curriculum by Brudney and Chirelstein, along with the new economic theories of the firm, provided the analytical tools for understanding the new deals transforming corporate law practice in the 1980s, and how the legal system should respond to those challenges. The groundbreaking article by Frank Easterbrook and Daniel Fischel in 1981, which advocated a change in the fiduciary standard applied in takeovers, integrated the finance and agency costs literature into a theory of takeovers informed by Manne's central 1965 insight (the market for control functioned as a disciplining mechanism for managers).[13] In contrast to when Manne was writing, the timing was ripe for these ideas to take root in mainstream discourse; the old doctrinal mode of analysis provided no value added and was abandoned as hopelessly inadequate to the task. The learning of modern finance and the economic theory of the firm enabled a new generation of scholars to craft rationales for advocating significant alterations of the fiduciary standards courts applied in acquisitions. They

[13] Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981). Parallel contributions were made by Lucian Bebchuk and Ronald Gilson, who engaged in a debate with Easterbrook and Fischel over the proper extent of management responses to bids in the November 1982 issue of the Stanford Law Review.

were able to draw support in that endeavor from a sizeable empirical literature that was developing that demonstrated significant gains to shareholders from hostile takeovers. Although the courts never came over entirely to the dominant perspective in the academic literature (which advocated restrictions on management responses to hostile bids), that literature was without doubt one of many factors affecting courts' perception of takeovers, and, in particular, the Delaware Supreme Court's 1985 revision of the fiduciary standard applicable in the hostile takeover context.[14]

It is important to highlight the symbiotic relationship between practice and legal scholarship as it was developing in the 1980s, as this relation is a critical factor to which I will return when discussing implications. The generation of corporate law scholars coming of age in the era of hostile takeovers embraced the interdisciplinary approach that had distanced Manne and Winter from their contemporaries. At the same time, Wall Street was being populated by individuals, often referred to as "quants," who were trained in the new asset pricing models and quantitative methods. Investment banks also became heavily involved in all stages of the takeover process; takeovers were lucrative and the banks offered needed valuation skills. Law firms followed suit, becoming increasingly conversant in finance as well, working alongside the investment banks to devise more effective strategies for companies' defenses and responses to defenses, and to make sure complex merger documents embodied understandings regarding warranties and representations, and protected buyers' investments and sellers' fiduciary

---

[14] The literature was cited in the Delaware Supreme Court's decision to enhance judicial scrutiny, although the Court also explicitly rejected Easterbrook and Fischel's advocacy of a rule of managerial passivity: Unocal Corp. v. Mesa Petroleum Co., 493 A. 2d 946, 954-955 nn. 9 & 10 (1985). For a discussion of the many factors, political, social and economic, affecting the Delaware courts' takeover jurisprudence see Jeffrey N. Gordon, Corporations, Markets, and Courts, 91 Colum. L. Rev.1931 (1991).

obligations. This was a period of ferment and innovation; lawyers' creative ingenuity in fashioning defenses was reflected in a new colorful terminology of crown jewels, white knights, bear hugs, greenmail, scorched earth and Pacman defenses, golden parachutes, poison pills, and the like. Notwithstanding considerable efforts to derail these developments legislatively, the new transactions were here to stay.[15]

In academia, the economic analyses of Manne and Winter received empirical support, as event studies tested the competing hypotheses advanced by Manne regarding merger motivations and by Winter regarding state corporate law. The studies' findings were most consistent with the efficiency (managerial disciplining), rather than anticompetitive explanation of mergers and the pro-investor (race to the top), rather than manager exploitation (race to the bottom) interpretation of state law, the positions espoused by Manne and Winter that had cast them as intellectual outliers earlier.[16] This is not to say that contributors to the field did not, or do not, continue to have strong substantive policy disagreements or dispute the interpretation or significance of empirical findings. They did and do. But there was now a consensus on the appropriate mode of analysis – that it should be informed by the new economic theories of the firm and finance. Although prominent practitioners questioned the use of economics in the academic literature, disputing conclusions as wrong-headed, their practice demanded that they too become increasingly conversant in finance, and they did, as they worked on deals in tandem

---

[15] For a discussion of state and federal efforts to regulate hostile takeovers see, e.g., Roberta Romano, The Future of Hostile Takeovers: Legislation and Public Opinion, 57 U. Cin. L. Rev. 457 (1988).

[16] E.g., Espen Eckbo, Horizontal Mergers, Collusion and Stockholder Wealth, 11 J. Fin. Econ. 241 (1983); Peter Dodd & Richard Leftwich, The Market for Corporate Charters: 'Unhealthy Competition' vs. Federal Regulation, 53 J. Bus. 259 (1980).

with investment bankers.

The influence of finance theory did not end with its impact on corporate practice and legal scholarship, but rather extended importantly to the courts and U.S. Securities and Exchange Commission. In the 1980s, several remarkable judicial opinions used the learning of modern finance in fashioning legal rules. In 1985, the Delaware Supreme Court revised the longstanding methodology used for appraisal (the statutory right to receive the "fair" value for shares acquired in a merger as determined by a court) to include any method generally accepted by the financial community (by which the court meant modern finance).[17] In 1988, the US Supreme Court accepted the efficient market hypothesis as the basis for demonstrating proof of reliance in federal securities fraud litigation.[18] Following the Supreme Court's lead, the SEC began applying the event study technique in insider trading cases to identify liability (whether false disclosures or omissions were material) and to measure damages.[19] In addition, throughout the 1980s it opposed managers' defensive tactics against hostile bids, influenced by the finance literature which had assimilated Manne's understanding of the market for control. As Kenneth Lehn has noted, in what is perhaps the "ultimate compliment a scholar can receive from his profession," there was a marked decline in citations to Manne's article on mergers in the Journal

---

[17] Weinberger v. UOP Inc., 497 A.2d 792 (1985). Rutheford Campbell tabulates how the methods applied in Delaware appraisal cases thereafter changed considerably, producing more economically rational valuations. Rutheford Campbell, The Impact of Modern Finance Theory in Acquisition Cases, 53 Syracuse L. Rev. 1 (2003).

[18] Basic Inc. v. Levinson, 485 U.S. 224 (1988).

[19] Two former SEC economists pinpoint the initial cases in which the SEC made use of the methodology as occurring in 1988 and 1989, citing Basic v. Levinson as providing the "intellectual basis" for the application. Mark L. Mitchell & Jeffry M. Netter, The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission, 49 Bus. Law. 545, 548, 572-77 (1994).

of Financial Economics (the "predominant finance journal [publishing] papers on corporate control") as the number of publications on takeovers exponentially increased, suggesting that "the ideas espoused by Manne in 1965 [were] now so commonly accepted by financial economists" that they did not feel the need to cite anything in support of those propositions as they had in earlier years when the transactions were novel, the literature new and the article was frequently cited.[20]

Modern finance and the economic theory of the firm offered analytical insight not only into takeovers. Easterbrook and Fischel's important book, The Economic Structure of Corporate Law, published in 1991,[21] coinciding with the decline in takeover activity at the end of the 1980s, synthesized the whirlwind changes in the state of knowledge, to which they had significantly contributed. It is the other bookend to the Brudney and Chirelstein casebook, delineating the time frame within which the field was transformed. For the book's publication marked the end of the revolutionary phase in corporate law scholarship, as modern finance and economics had come to be the conventional analytical approach to corporate law.

The most important reason for the adoption of the new analytical approach was, no doubt, the beauty of the intellectual fit. Modern finance had become the language of business, and lawyers needed to be knowledgeable about it in order to serve their clients; as takeovers flourished, those deals set the teaching and research agenda, and finance and the theory of the firm provided the tools for analyzing the deals and the novel legal issues they raised. In

---

[20] Kenneth R. Lehn, Some Observations on Henry Manne's Contributions to Financial Economics, 50 Case Western Res. L. Rev. 263, 266 (1999).

[21] Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of the Corporation (Cambridge, MA: Harvard Univ. Press, 1991).

addition, the metric of event studies, the impact of corporate policies on stock prices, meshed well for policy analysis within the framework of U.S. corporate law, which imposes fiduciary obligations on directors to act for the benefit of the shareholders. Finally, the Anglo-American legal tradition has been instrumental in its approach, and this jurisprudential perspective is most consonant with interdisciplinary research that is grounded in positive theories of behavior: because the objective of the law is to affect behavior, in this view, a theory that can predict behavior is essential to get the incentives right. Modern finance and the theory of the firm offered plausible theories of investor and manager behavior and therefore quickly came to be pervasive in analyses of corporate law.

After the Revolution

The revolution in corporate law has important implications for all aspects of business law education - research and teaching. I will focus on three distinct sets of implications, those involving the law school curriculum, law schools' relation with other units of the university in which they are situated, and law schools' relation with the practice of business law.

Curriculum

As I hope is self-evident from the earlier discussion, the transformation in legal scholarship and practice has created a need for technical proficiency on the part of business lawyers and teachers. With regard to the future, the level of technical proficiency will surely only be greater than present-day requirements. In response to these developments, law schools have added courses on corporate finance and mergers and acquisitions (often referred to as deals courses) to their curriculum. But that response, in my judgment, is thoroughly inadequate.

The central problem is that those newer courses combined with other courses in the typical law school curriculum do not provide the technical level of knowledge that business

lawyers need to master to be at the forefront of their profession. (It goes without saying that the education is inadequate for a career in business, which some of our graduates pursue, but such preparation does not go to a law school's core educational mission.) Moreover, even leading law schools are not well-positioned to provide that knowledge on their own: most law faculties do not have the staffing to offer, for instance, the requisite class sections of finance, accounting, and so forth; they often barely manage to staff the introductory and a few advanced corporate law courses with tenure track faculty. Some law firms provide instruction in accounting, and some consulting firms offer mini-business school programs for new employees who lack an MBA, but the typical firm-level resolution to this problem is best characterized as a sink or swim approach.

A cavalier response by some might be that law students are extremely bright and they can learn what they need to know on the job, rationalizing the institutional indifference to the situation. Such a flippant answer can most politely be characterized as misguided, less politely as silly. It is plainly not tenable for a professional school to refuse to meet its obligation to educate individuals for their profession. If that is not central to its mission, then what is? In due course a law school that chose to follow such a path would find its reputation in a downward spiral. Yes, students are bright, but we are failing them when we do not provide them with the opportunity to master the essential knowledge that they need for having successful careers, particularly hard-to-master knowledge that is neither easily nor quickly mastered on one's own. If you think I am overdramatizing the situation, ask yourself, how many autodidacts in the accounting or finance profession have you met lately? While the best business lawyers do not need to become financial economists or accountants, they need a thorough working knowledge and mastery of the concepts and the literature.

It is also not a satisfactory response to shrug off the problem by acknowledging that there

are likely to be equally substantial gaps in law school graduates' knowledge concerning the legal landscape as there are in their technical business knowledge. While I would agree that the former gap is also of concern, it is the stuff for which on-the-job-training is feasible. In short, law schools are doing a poor job of it when it comes to educating the preeminent business lawyers of the next generation and the fact that few schools are doing a good job is no excuse. We ought to do something about this unacceptable situation; simply put, the law school curriculum has not caught up with the transformation in the profession and legal scholarship.

But it is also not the comparative advantage of law schools to provide the sort of general business education that the contemporary business lawyer requires to be able to offer the highest quality service to clients and society. It seems to me that the most straight-forward solution to this problem lies in actively encouraging students seeking a business law career to enroll in joint degree programs with management schools. But a widespread implementation of this solution is currently not feasible because the student must forego a year of employment and incur an additional year of tuition in the existing joint degree program framework, which is a costly impediment to most individuals' enrollment in such programs. To obtain the necessary knowledge without being in such a program is also a non-starter for the most part. This is because it is difficult, sometimes impossible, for a non-joint degree student to be able to enroll in core management school courses, as enrollment in those classes is typically capped, so that management schools can better educate their own students. And law schools, following ABA strictures, limit the number of non-law school courses that can be taken for credit. Furthermore, it would be, in my judgment, both infeasible and unwise to attempt to change a law school's character by making numerous appointments to staff those types of courses in the law school instead. This self-evident interdisciplinary curriculum failure has a straightforward

interdisciplinary solution that does not require altering the character or organization of law schools.

The solution to the curriculum problem, in my view, entails greater integration of the law school business law and management school curriculums, through the development of a more streamlined JD-MBA joint degree program than exists at present, working within our established joint-degree format. In such a program, students would acquire the two degrees in three, rather than four years, the same time frame in which it takes to obtain a JD. The creation of such a program is not a fantastical suggestion: Northwestern has recently established such a program. The ABA's recent modest increase in the required number of law school credit hours should have no impact on this type of program, but other clarifying changes in credit rules, which require law schools to permit students to graduate in five semesters, will quite likely encourage schools to emulate Northwestern's lead. At Yale, we are currently carefully exploring the possibility of establishing a pilot accelerated joint degree program between the law school and management school. I am convinced that such a program offers the most promising route for the education of the next generation of the leading business lawyers and would benefit both schools.[22]

A student interested in a career in business law would, of course, not have to follow this course of study, and we would not expect all students with such an interest to do so; the critical

---

[22] The University of Virginia law school has followed a different path, and created a law and business program that requires a course in accounting and finance (offered in the law school) and thereafter the students enroll in business law courses with a specialized, deals-orientation. While this is an interesting innovation, it concentrates on providing legal skills with less focus on technical foundations; in my opinion the preferred balance is the reverse, which a streamlined joint degree program would achieve, because the legal knowledge, as noted earlier, is more easily acquired on the job than technical knowledge.

factor is that we would be providing an option for students who wish to have the opportunity to develop a thorough mastery of the knowledge necessary for a career in business law or business, that they cannot obtain through the standard law school curriculum. The existence of the program would be of considerable benefit even to those students not enrolled in the joint degree program, because, as we would in all likelihood jointly list some core management school classes, capacity permitting, law students who are not enrolled in the joint degree program would be able to take a management school course which they might not be able to do as non-degree candidates given current enrollment restrictions.

The state of education for students seeking to pursue a career in business law teaching is, in my judgment, as troubling as that for those planning to enter business law practice. Paralleling the need to innovate upon existing JD-MBA programs, I believe that a new curricular initiative between law and management schools is essential to train business law teachers, a joint JD - PhD in finance. We have just established such a program at Yale, and it is, as far as I am aware, the first in the country. Our program pares down the requirements for the PhD to the management school courses that provide the training that is most necessary for business law research - finance, microeconomics, financial accounting - eliminating more esoteric courses. More important than permitting expedited progress toward completing a PhD, this law and finance degree program provides greater focus and structure, than an economics PhD program (or a general business school PhD program), and should be especially useful for an empirical research agenda, which is where corporate law scholarship has moved over the last two decades.

My generation of corporate law academics, the first generation involved in the intellectual revolution, could get by auditing graduate courses in finance and econometrics to get up to speed, since the field was new, and what by today's standards was relatively primitive

knowledge of finance and economics, could produce a contribution. A few in my generation, and an increasing number in the succeeding generation, have PhD's in economics as well as law degrees. But a problem with the latter route and the reason why we created a new program with the management school is that an economics degree is not the best match for business law scholarship.

As earlier noted, the building blocks of the revolution in corporate law originate most prominently in modern finance, which (as hopefully is clear) is a specialized field of economics. As a consequence, there is a highly imperfect match between the body of knowledge imparted in an economics PhD program and that which is critical for analyzing corporate law issues, and particularly for the direction in which the field has been moving, using quantitative methods. Graduate economics department programs at leading universities typically emphasize theory, mathematical modeling, more than business school graduate programs, which, being professional schools, have, as a rule, a more applied bent, and joint degree candidates studying in economics programs, reflecting their training, invariably perceive that theory is a higher calling than empirical research.

Formal modeling has, in fact, played an important role in advancing legal scholarship and I should not be understood to be saying that it is not valuable. Rather, the present state of corporate law scholarship suggests to me that there will be a lower likelihood of value-added from pursuing formal modeling than from quantitative research at this point in time. Much of the first generation's work was directed at using the intuitive insights of finance and economics to analyze and rationalize the body of corporate law and to incorporate the new control transactions within it. Not surprisingly, that work often offered starkly divergent policy conclusions. More formal models following the earlier work have not appreciably advanced the

policy debate. In fact, much of the more recent work is a straightforward replay, except with, on occasion, more equations, of the 1980s literature debating the same issues. We are at a point where what seems to me more valuable than further sophisticated modeling is empirical research that facilitates the sorting out of theories in order to advance the state of knowledge. This argues for a more applied, middle-range approach most consistent with what is emphasized in a management school PhD program.

Readers of this paper who are familiar with my own research agenda might note that what I have described and am advocating sounds a bit more than self-serving, as it is the style of my research. That is true. But this is the direction in which the field, for good or for worse, has been moving – many of the younger corporate law scholars today have been increasingly turning to undertake empirical research, at times working jointly with financial economists, and for the succeeding generation the level of technical sophistication required for making a contribution will surely only increase. Yale's new JD-PhD in finance program will meet that challenge for Yale Law School graduates.

There are two important reasons why empirical research has caught on with contemporary corporate law scholars and will in all likelihood continue to do so for quite some time. First, policy disputes are, at least in principle, resolvable empirically when there is consensus on ends, as there is among most U.S. corporate law scholars since the field was transformed with the application of finance and the theory of the firm (a consensus that the objective of public, for-profit corporations is to maximize shareholder wealth). Second, empirical research has become far more accessible and cheaper to undertake than decades ago when the revolution in corporate law began. When I started law teaching over 20 years ago, for example, I had to use a mainframe at the central university to access my data and the statistical

programs that I was using to analyze the data; I had to drive over to a computer center a distance away to pick up bulky reams of paper with my results, which sometimes were not available until the following day, and so forth. Now one can do far more sophisticated statistical work at home on a personal computer; stock price data are directly downloadable from the web, powerful statistical programs run on PCs, and the results are virtually instantaneously available - plus the statistics programs can be run interactively so one can immediately rerun analyses to refine hypotheses and do robustness checks; results can be input directly into word processing programs, etc. And virtually all of this is done with no university charge for computer time. Simply put, the cost of undertaking this kind of research has dramatically declined. This trend also plays to the comparative advantage of law professors, who are more steeped in institutional knowledge than most financial economists. Given these facts, I am confident that Yale's new joint JD-PhD in finance program with the Management School will produce graduates well-prepared to excel in an academic career for the next generation of corporate law scholars, and will come to serve as a model for other institutions.

Relations with Management Schools and the Profession

The revolution in corporate law has further implications that concern the law school's relation with the rest of the university and the practice of business law. It should come as no surprise that with more sophisticated knowledge of finance and economics becoming the stock in trade, law school faculty in the corporate field often intellectually share more in common with management school than with law school colleagues in non-business law areas. Law school and management school faculty are often studying similar issues using similar techniques. Indicia of this state of affairs are law and finance conferences organized jointly by law and business schools and publications of articles jointly authored by law and management school faculty.

The quantum leap in specialization and technical sophistication of the business law academic has important ramifications for law schools. It suggests that larger law school faculties and law schools associated with universities with management schools that have strong corporate finance groups (and good relations between the schools) will have a comparative advantage over smaller schools and those without such positive management school relations, in recruiting business law faculty and in maintaining first-rate business law programs. This is because given the specialized nature of their research, corporate law academics will want to be part of a large business law group or to develop close ties with management school faculty, in order to compensate for the more limited input that non-business law school colleagues can provide for improving their work. This phenomenon should be of particular concern to smaller elite law schools because it is doubtful that a school can maintain itself as a preeminent institution by becoming a niche school and ceding business law to its larger competitors.

What can relatively small elite schools do without changing their character and becoming large schools, beyond modestly increasing their business law faculty and encouraging cooperation with other units of their universities to be competitive in attracting quality business law scholars? One adaptive device to the new environment with which many schools have already been experimenting is the establishment of business law centers. The focus of these centers – and certainly the objective for establishing such a center at Yale several years ago – is to enhance the intellectual life of the law school in the business law area, and more specifically, to enhance the quality of faculty research and of students' educational experience, by increasing exposure to and engagement with contemporary business law issues. Corporate law centers typically sponsor programs that invite business law faculty from other schools (as well as management school faculty) to share their research, thereby expanding, albeit temporarily, an

inhouse faculty group. While nearly all elite and both large and small law schools have created such centers, I believe that there is more value-added from having a center for smaller schools because a center's activities can mitigate the school's size disadvantage while the cost (in faculty time and resources) is not much greater for the small than for the large institution.

Corporate law centers, are very much works-in-progress and the scope of their functions are still being defined through innovation and experimentation. But there are two common focii of activities that I believe bear special notice as they will, in all likelihood, expand. First, many centers have sought to link up with distinguished alumni, in a variety of formats, including conferences, colloquia, and more informal sessions. The intermediation between law schools and the profession assumed by the centers is a trend that, it seems to me, will become of increased importance because, as business law faculty move in the direction of greater technical sophistication, they run the risk of losing touch with the transactional issues of the day and thereby producing scholarship that will be arid and irrelevant (as the best corporate law scholarship has been intimately related to addressing the issues of the day). Centers are an ideal mechanism for keeping the academic community connected with new developments because the alumni who often generously support a center's activities and participate in the programs are also the best source for up-to-date transactional information. This has certainly been our experience with Yale's corporate law center's advisory board.

Second, centers have a role, as yet still largely uncharted, in the steady internationalization of corporate law practice that we have observed for some time now. Comparative work on corporate governance is an active area of research in both law and finance, with corporate law and finance scholars in the US, Europe and Asia participating in numerous conferences and joint research activity. The boom in cross-border mergers and the concomitant

rapid changes in corporate law regimes that have been occurring in Europe and Asia in recent years, suggest that the research activities of business law centers will have a decidedly greater international and comparative focus.

The description of corporate law centers' programs presented thus far has emphasized the ways in which they foster faculty research; but it is important to note that Yale's center wholeheartedly welcomes, and seeks, student participation, and its activities are intended to complement the curricular initiatives that I have described earlier. Moreover, the center's programs have another important function for students. In law schools such as Yale, which have a large and distinguished public law presence, students interested in business law can feel left out or intellectually isolated. Whether or not such perceptions are accurate, corporate law center programs address such perceptions by offering intellectual engagement and support for that group of students, as well as providing the opportunity for students to project better what a successful business law career could be like by facilitating student-alumni interaction in an academic setting.

Conclusion

I have tried in this paper to describe the state of corporate law today, how we got here and to suggest where we should be going. Corporate law scholarship and practice were completely transformed in response to intellectual currents in finance and economics and new transactional developments, which called for comprehensive legal innovation. Unfortunately, the law school curriculum has lagged far behind that revolution. The good news is that law schools can rectify this situation without having to make drastic changes. Law schools just need to apply what has been an interdisciplinary tradition proactively to the business law area, as experience has demonstrated that a less attentive approach will not do.

european corporate governance institute

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities.*

The ECGI will produce and disseminate high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It will draw on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

www.ecgi.org

european corporate governance institute

ECGI Working Paper Series in Law

Editorial Board

Editor	Guido Ferrarini, Professor of Law, University of Genova & ECGI
Consulting Editors	Theodor Baums, Director of the Institute for Banking Law, Johann Wolfgang Goethe University, Frankfurt & ECGI Paul Davies, Cassel Professor of Commercial Law, London School of Economics and Political Science & ECGI Henry B Hansmann, Augustus E. Lines Professor of Law, Yale Law School & ECGI Klaus J. Hopt, Director, Max Planck Institute for Foreign Private and Private International Law & ECGI Roberta Romano, Allen Duffy/Class of 1960 Professor of Law, Yale Law School & ECGI Eddy Wymeersch, Professor of Commercial Law, University of Ghent & ECGI
Editorial Assistant :	Paolo Casini, “G.d’Annunzio” University, Chieti & ECARES, Lidia Tsyganok, ECARES, Université Libre De Bruxelles

Financial assistance for the services of the editorial assistant of these series is provided by the European Commission through its RTN Programme on European Corporate Governance Training Network (Contract no. MRTN-CT-2004-504799).

www.ecgi.org\wp

european corporate governance institute

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (www.ecgi.org/wp) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Fin.html
Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html