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ROUNDTABLE DISCUSSION: THEORY'S CONTRIBUTIONS TO CORPORATE LAW AND PRACTICE

Chicago-Kent College of Law
April 6, 2001

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JOHN COATES: Before we get into a back-and-forth on theory and practice, and discuss how they differ, how they are similar, and how they can help one another, I want to talk about a few theories that might help us explore whether the practitioner perspective is or isn't very different from the academic perspective. The first theory I have in mind is efficient market theory. The efficient market theory, in extremely general terms, is that financial markets are efficient, i.e., one can look at prices of financial instruments and infer a great deal of information from the prices and the movements of the prices. Put differently, the efficient market theory says that it's very hard to beat the stock market. I didn't want to give the impression in my talk[1] that I find efficient markets theorizing useless or wrong in any general

1. Professor Coates's talk discussed some real-world findings that diverged from theorists' predictions about takeover defenses.

sense. I just think it can be taken too far. But I'll say, as a general matter, efficient market theory has had a major influence on the law. All the major players in the securities industry certainly have been affected by numerous applications of efficient markets theorizing.

To the extent that we have time, we can also discuss game theory[2] and agency theory.[3] All of these theories, and the academic world, depend heavily on some fairly controversial assumptions about how rational people are, how or whether people systematically act in irrational ways, and how efficient other mechanisms may be in trying to constrain irrationalities when they occur.

MARKET EFFICIENCY

JOHN COATES: With that general introduction, let me throw it out to the panel. As practitioners, to what extent do you assume that the stock markets and financial markets, in general, are working fairly well? In other words, how often do you find yourself trying to second-guess those markets, and how often do you simply take what's reflected in market prices as an assumption and work from it? I'm going to pick first on Robin, the person at the end of the panel, since she's probably the most directly involved in financing transactions. So, what do you think? Are markets efficient?

ROBIN ENGELSON: I think there's a great inefficiency in markets. As lenders, we use the market to help us establish the enterprise value of companies, and that impacts decisions about debt and equity capacity (both for private and public companies). But the market is just a guide; some of the biggest mistakes as well as some of the greatest rewards are found in capitalizing on the inefficiencies in the marketplace. The market has an extraordinarily difficult time with relative multiples within industries. While analysts may attribute this

2. Game theory has been defined as

> [a] general analytical approach to modeling social situations in which the information, possible actions, and motivations of the actors or *players* and how those actions lead to outcomes are all specified in detail. In contrast, the competitive equilibrium model does not specify what would happen if the demands of consumers exceeded the available supply.

PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION AND MANAGEMENT 599 (1992).

3. Agency theory is concerned with the divergence of interests between a principal and its agent. One important application of the theory is in explaining the relationship between a firm's shareholders and its managers. *See* CHARLES E. MAXWELL, FINANCIAL MARKETS AND INSTITUTIONS: THE GLOBAL VIEW G-1 (1994) (defining agency theory as one that "explains and investigates costs associated with disputes between management and shareholders").

to management talent, market position, or other competitive factors, there is often real opportunity (inefficiency) in the discrepancies.

JOHN COATES: Does anybody on the panel disagree?

DAVID VAN ZANDT: I would say if markets are efficient in the way you were talking about it, or in the Nirvana sort of way, we should all pack up and go home because we don't have jobs anymore. I think part of being in business is identifying places where you can increase efficiency and take advantage of opportunities, whether it's arbitrage in financial markets, but just generally in business looking for places where you can be much more efficient. So, if you're in the financial business, you're constantly looking for places to contribute to overall efficiency. I think the question is a little odd. It's a question we get asked by our students all the time. They like to argue about efficient markets from a very abstract sense, but the reality is that it's a question of where the opportunities are.

JOHN COATES: Fair enough. Let me ask the question slightly differently and make it more one of relative institutional competence. Let's say you are working for a public company client, the client announces an acquisition, and then the stock market price of that client falls dramatically upon announcement of that acquisition. This happened several times recently. When Phillips bought Tosco a few weeks ago, for example, it lost about 7 percent of its market value when they made the pronouncement.[4] What is your reaction to that? Do you just sit with your client and agree that the markets are all inefficient and therefore we should just ignore this? Is this something that can realistically just not enter into your work with clients? In other words, if David's strongly stated point that business people are there to ignore markets, that's their job—

DAVID VAN ZANDT: Well, I don't think I said that. I never said that. No, I said that business people are there to take advantage of all the information sources. The fact that your stock dropped 7 percent is a signal of something. It could be that the analysts don't believe in your business plan for that merger, or they think you're wasting corporate assets in undertaking that. It could mean that they haven't

4. Shortly after the purchase announcement, Phillips shares dropped from $58.13 to $53.35, or $4.78 per share. Nikhil Deogun & Alexei Barrionuevo, *Phillips to Buy Tosco in $7.49 Billion Deal*, WALL ST. J., Feb. 5, 2001, at A3 (stating that Phillips shares were $58.13 at the time of the announcement); *New York Stock Exchange Composite Transactions*, WALL ST. J., Feb. 6, 2001, at C5 (listing Phillips shares at $53.35 shortly after the announcement); *see also* Nick Snow, *Phillips Makes Surprise Swing Downstream*, OIL & GAS INVESTOR, Mar. 2001, at 141 (stating that the purchase announcement stunned investors and Wall Street oil analysts).

yet recognized the efficiency that you actually see, or that they don't believe in your prediction of where the market is headed or where the world is headed. That's what I think it is—it's a piece of information you would use. You wouldn't ignore it at all.

ROBIN ENGELSON: I guess the real question here is whether it's relevant or not because it's only relevant to the extent to which the company needs the markets in order to complete the transaction, i.e, they are going to do a secondary offering or something like that. In fact, I have a public client right now that has not announced an acquisition. They have the option to finance the acquisition either with a secondary offering or by adding more debt. Many companies don't have the option to do either. But for those who do, if the market doesn't react well to the announcement, they can elect to postpone the secondary until they've proven out the validity of their strategy. It's not clear whether the market is temporarily right or wrong; it is clear that if the company didn't have the option that they would have to pay much more attention to the market's reaction. I've rarely seen a company that didn't need to raise additional public equity change its mind on an acquisition because the market didn't react well.

JOHN COATES: So, market reactions obviously can constrain choices in a straightforward way. Lee, in the world of sovereign debt, are there market prices for sovereign debt bonds that you can look to to get guidance in doing workouts and so on?

LEE BUCHHEIT: There are market prices. But, a sovereign's *ability* to repay is only part of the analysis. History has shown that a sovereign's *willingness* to repay—in light of domestic political factors and the international environment—is equally important. The analysts who look at the sovereign debt market must therefore have a wider peripheral vision than their corporate counterparts. Just on the corporate side, it seems to me that if your client is a chief executive officer who took the decision to make an acquisition that disappointed the market, presumably that conversation goes only one way. You don't sit around and say, "We got it wrong, George." You say, "The markets are unenlightened, and we had a failure to communicate." However, if you take someone in Robin's position, or anyone who is in the position of looking at the company and being asked to buy their equity or their debt, it's something of a self-fulfilling prophecy. Their response is to say, "The markets valued you this way and that is what I have to take as my basic datum for purposes of determining what your borrowing capacity is, what your payment capacity is, and so forth. It doesn't matter to me as the new investor whether the markets have analyzed you improperly, have been unenlightened, or capricious. It is simply a fact."

JOHN COATES: Robin, let me throw this one out to you. If, in fact, the market reacts very negatively to a transaction that one of your borrowers has announced, does that change your perception of the borrower?

ROBIN ENGELSON: No, because it doesn't change the company's underlying cash flow. And it doesn't change the underlying value of the company's assets. So it's not really particularly relevant unless your only exit of the loan is to sell the company in the public market. But typically that's not the first exit.

JOHN COATES: So, perhaps we can divide loans into two types: loans that are heavily dependent on assets, where the management quality might not significantly influence your ability to get repaid completely, and loans where you are taking more risk that's associated with the quality and competence of the management team. And if the company announces a series of transactions where there's an inference that the company has done a bad job of communicating with the analysts, that doesn't then start to affect the way you think about this management team?

ROBIN ENGELSON: That's a separate question from whether it impacts whether you can make the loan. Typically, in a non-asset situation, where you're making the loan based on a multiple of cash flow of the company, the industry the company is in has to trade within a certain range. So, if that management team over a prolonged period of time continues to make a series of bad decisions, then its enterprise value would tend to trade at a lower multiple of that range. It might ultimately limit somewhat the upside on the senior debt capacity for that company.

GARY FUNDERLICH: I think to the extent that you are going to assess management by relying on a drop in market price based on the announcement of an acquisition, you have to step back and consider the complexity of the transaction. You must also understand how the analysts are applying their traditional views of the company, or their traditional theories about the company, against what they think the new company will look like.

Moreover, in instances where you have a company moving from one industry category to another, the analysis is not as straightforward. For example, it's been very noticeable for us that as we [i.e., AOL Time Warner] move from the pure internet category to perhaps the more traditional media category, the analysts and the market seemingly still haven't decided how to think about us. There is a series of days where I can tell you the internet stocks move and our market price tracks that move, the traditional media stocks move and we track that move, and then one or both of them will move and we either do not move or we move in the opposite direction. I can't believe that you can necessarily imply from such movements that it's an inability of management to communicate properly with the analysts, or even question management's ability to go forward with a new company. So much information has to be disseminated, assimilated, and acted on after an announcement that there is a time lag before the information is properly reflected in market price. So, that initial drop does not necessarily indicate that management or the deal is bad.

JOHN COATES: So, the general consensus on the panel seems to be that even where the market reaction is significant, unless there is an immediate problem, like the company needs to turn to the market to raise more cash, you really don't consider transactions that may indicate poor communication by management to be a very significant indicator of management quality. Is that a fair assessment? Larry, do you disagree?

LARRY ISAACSON: I have no view on this.

JOHN COATES: No view whatsoever?

LARRY ISAACSON: No. But regarding the efficiency of the markets and how that pertains to my practice, I think every deal I've done over the last four years has been based on an inefficient market and the markets' inability to work together. All of my clients are investment banks and commercial banks, and they're simply taking advantage of the fact that markets don't work together. The inefficiencies are quantifiable in the fees financial institutions are getting on every deal. So, I hope it continues. And as long as it continues, the clients that I'm servicing will continue to make money.

GARY FUNDERLICH: In my experience, if you were to rely on what is happening with a prospective transaction partner's market price to determine whether to go forward with a transaction, you would have missed some good opportunities and taken on some really bad ones. I am not aware of a time where a company I have worked with actually sought out a deal based on the other side's high market price or stepped away from a transaction because of the other side's low market price. In our business, we've seen both over the last couple of years, and it still doesn't really influence how we view the other side to great degree.

JOHN COATES: Dean Van Zandt?

DAVID VAN ZANDT: Just from the M&A [(mergers and acquisition)] market, one of the things you try to do is look at the market pricing of a company, and you're looking for somebody often times with a lower multiple. But the reason you're doing this is not an automatic decision. You're trying to cull out the ones at low multiples because they have no market, or there's nothing you can do with those companies, versus the ones who have a low multiple because of, say, poor management. You can replace the management and put better management in that company. Another way of saying that is that the company has some markets it could exploit but hasn't done so very effectively. So, I don't think it's right to say the market has no impact on the decision. You're not going to buy one of the "dot-com" companies a few months ago, for example, because they have extremely high multiples and there's not much you're going to be able to get out of those. But, on the other hand, you don't just go out and buy low-multiple companies. You buy the companies that, looking at their business plan or looking at their markets, you think you can do some things with the company that will raise the multiple, raise the market capitalization of the company.

ROBIN ENGELSON: So, aren't you really asking whether the markets' apparent inefficiency is a result of an inability to communicate a difference of opinion?

LEE BUCHHEIT: That's right.

JOHN COATES: Right.

ROBIN ENGELSON: But with perfect information, and with everyone understanding specifically what the synergy is and filtering out the noise of conglomerates where subsidiaries aren't performing from where their true value is and so on, if that were perfectly known, what would the case be?

GARY FUNDERLICH: I don't know that I would go along with that. There may be some inability to communicate, but on the other side I think that the analyst community has created theories and expectations of its own. Management may be communicating exactly the information that needs to be communicated, but it may not be what they think you should be telling them or what they want to hear.

DAVID VAN ZANDT: I don't think it's one way. I think it's both sides. When there is a difference of opinion between you and the analyst community, you have one vision of the company and its market, and the analysts, right now, have another vision of the company and the market. One of the two of you is closer to the ultimate truth of that, and it could be that the analysts are right in this particular situation or it could be that your business plan is correct.

ROBIN ENGELSON: Then there are other issues, such as stocks that are not widely publicly traded, so that even the dissemination of good information or poor information doesn't move the stock one way or the other because it just doesn't have enough float.

JOHN COATES: I like Robin's distinction of inefficiencies that arise because information is hard to communicate and not equally shared versus the notion that there are just simply differing opinions. Even with the same information set, people can have very strongly different views of what the future is going to bring. If the only thing that mattered was cash flows, if we all could agree on what the cash flows were going to be, then we would all have a consensus on what a given price ought to be and therefore there wouldn't really be much more to say. So, cash flows, even though they are obviously quite critical to coming up with a view about the future, can't be all that one cares about if you really believe in this different opinion theory. I think this different opinion theory is hard to convince academics of. In other words, I would say that a prejudice exists in academia. It's not a prejudice against the idea that information is not important to improving on market prices as a signal. Rather, the prejudice would be that once everybody has the same information we all basically would agree. And what's interesting is that implies on some level that value doesn't just all go to cash flow.

I want to play devil's advocate for one more round here on efficient markets and then move on. Suppose you're now in court because when you went to a given borrower, or invested in or bought a given company, you were lied to about the information that was important to you in making the loan, buying the stock, or doing the deal. What should the damages be? Is the court, in trying to come up with some measure of damages, appropriately using market prices as a way of measuring those damages? Basically, the answer that is currently enshrined in federal securities law is that the market price determines the damages in these kinds of lawsuits, if you can find a market price.

So, now, to the extent that all of you think fairly skeptically about market prices as being the most important—or even an important—source of information for you in making the business decisions, what does that suggest about whether the courts have got it right? Should both parties be able to throw additional information into the mix in trying to prove damages one way or the other? You really can't do that now in federal securities law. Any views on that? This is moving out of the business world into policy, but this is an interesting situation where theory hits you all as practitioners, where the law takes theory up into itself and enshrines it. And then it really matters to you in practice because when you're making a loan, you're making a loan against the possibility of enforcing the lending agreement. If you try to enforce the lending agreement in court and the law will only allow you to collect damages in a very particular way, you've got to take that into account. So, what do people think about that enshrinement of the efficient market theory?

DAVID VAN ZANDT: No offense to Vice Chancellor Jacobs or anyone else who is a judge in here, but my view would be that I would much rather have it tied to an objective measure like the market. Now, you could bring in evidence as to whether or not a particular company has a deep enough public market for this valuation process to work. But there are many advantages to having an objective number that you can determine at a particular point in time so that you don't let the lawyers get into all sorts of abstract valuation issues. You have a completely different problem when it's a private company or a company with a very thin market. But I think if you have a deep market, the ideal in that context ought to be to rely almost solely, if not solely, on the market price. This is in part because of judges' institutional competence—they've got a whole range of expertises, but doing valuations, unless you're a very specialized court, is probably not one of them, particularly for federal judges.

LEE BUCHHEIT: John, I would have thought at least in the lending context it's fairly clear: if you lend money to a company and you have a basis for saying there was fraud in the inducement, your damages are the amount you lent, plus the interest on it, plus the penalty interest, plus your lawyer's fees in collecting it. And even if you bought the debt in the secondary market at a discount, I think the law would still say that your measure of damages is the same. That is what your judgment will be. Collecting on the judgment is quite another thing, but I think, at least in the lending context, it is very clear.

ROBIN ENGELSON: Yes, I don't think lenders are looking for damages, they're just looking for repayment of principal, interest, and fees.

GARY FUNDERLICH: You do not always have a measure as concrete as principal, interest and fees. Whether it's a good thing or a bad thing, I tend to go along with using market price. At least you've got an objective measure. However, I think that it goes a little bit further. If you valued the deal on something unique to you or the way you viewed the transaction, why not contract to the ultimate settlement? Give the court a proper calculation to apply if you don't believe in the market price.

JOHN COATES: In some sense, that is what lenders do, perhaps for precisely that reason. There is an interesting contrast between fraud that relates to debt and fraud that relates to equity investments in that in the latter you have a built-in measure of damages that's objective and different from the measure that would be derivable. Maybe the Supreme Court [in *Basic Inc. v. Levinson*] got it right,[5] not because the theory is a particularly good one, but rather it's just the best theory for the courts to use in particular and it really doesn't have any more general application than that. It's worth pausing at this point, though, because the New Jersey Supreme Court just rejected the efficient market theory, just rejected the fraud-on-the-market theory.[6] The court made the mistake that you all didn't just make, which is to jump from "markets obviously are inefficient" to "therefore we should just not really pay much attention to markets when setting damages."

RATIONALITY

JOHN COATES: Let's move on to a level that is slightly deeper, or more abstract, or sillier, depending on your perspective. The efficient market theory always has been grounded on the notion that individuals are relatively rational, meaning that they pursue relatively well-definable goals like wealth maximization given equal knowledge. So, theorists of that sort haven't traditionally accepted the notion that

5. 485 U.S. 224 (1988) (holding that applying a rebuttable presumption of reliance supported by fraud-on-the-market theory is appropriate).

6. Kaufman v. i-Stat Corp., 754 A.2d 1188 (N.J. 2000).

people act irrationally in any kind of systematic way. To what extent does that make any sense to you as practitioners? Is that real? Is that part of your world? Do people act in rational, predictable ways or do they act in predictably irrational ways in various settings? Any thoughts on that? Larry?

LARRY ISAACSON: I assume that all the actors in the capital markets are acting rationally. It's just that their separately acting rationally creates opportunities because they don't act together rationally. They act separately. So, for example, the deals that I do might combine the emerging market, sovereign debt market, the AAA,[7] investment-grade, and subinvestment-grade markets in the United States.[8] Those markets don't act together. And while each may act rationally separately, that in itself creates inefficiency and an opportunity on which people can capitalize. So, I don't assume that people don't act rationally, I just think that their rational behavior, which is investing in certain markets in certain ways, creates opportunities. At least it does in my practice.

LEE BUCHHEIT: I hope that they don't act rationally all the time, if by "rationally" you mean they always act without emotion. That would put many of us out of business. For example, if you're representing sovereign issuers of debt, you make your living trying to persuade otherwise sensible investors to give you their money, sometimes against a backdrop of not having repaid the last group of investors. Were the new investors acting in an entirely dispassionate way, they probably would reject that argument. Part of the lawyer's job is to present the sovereign client in a way that says to investors, "The dawn has come up in Ruritania, and we are a new country with a new president and so forth." Thus, it all depends on what you mean by "rational." If by "rational" you mean "rational but still susceptible to persuasion," that's the kind of counterparty I like.

JOHN COATES: That's a revealing description. I like that one. Gary, when you are negotiating business contracts with counterparties, how rational are they?

GARY FUNDERLICH: Ours is a tough world to strictly apply traditional ideas of rationality. If you look over the last couple of

7. The AAA market is the market for the highest-quality, safest debt. AAA is the highest rating that a rating agency such as Standard & Poor's or Moody's gives.

8. "Investment-grade" refers to the highest-grade bonds, graded BBB and above by the rating agencies. "Subinvestment-grade" refers to categories rated lower than the investment-grade categories (including BB, C, etc.).

years it is really difficult to say, at least at first blush, that people have acted rationally. However, to follow up on something that Lee just said, if you start to hone in on what one means by rational behavior, you may come to a different conclusion. If I come in as a subsequent creditor knowing you haven't paid, but I am able to get a couple of tenths of a percent better on my return or I have preferences or some other additional rights superior to the creditors who are ahead of me, is it irrational for me to do that, even knowing that my risk is higher? As long as the risk and return are properly balanced I wouldn't consider that irrational. Now, have I seen transactions where I would love to see the justification document that was done to get the deal through? Absolutely. However, if I knew that somewhere somebody or some group of people who used their best efforts have come to the conclusion that the risk and return potential is there, then yes, I would have to say they acted rationally. Even though on the surface probably not.

JOHN COATES: "On the surface, probably not." That's interesting. So, you actually do think in most circumstances there's some way to rationalize or justify things that appear to be quite irrational at first blush?

GARY FUNDERLICH: That's been my experience.

JOHN COATES: Interesting. And again, relative consensus on the panel.

Let me throw some theory at you. It used to be obscure, but over the last five or ten years it has been showing up in more practical applications. The theory goes generally under the name of behavioral economics or behavioral finance, and says that under a variety of conditions you can predictably find irrational behavior even in capital markets. One wonderful paper that I've seen recently involved a study of the people who went into online trading early.[9] The study dealt with thousands of people; it studied thousands of accounts and not just idiosyncratic moments.[10] Basically, people consistently overestimated their ability to do well.[11] The amount of their trading went up dramatically while the amount of their returns went down dramatically. Under traditional economic analysis this is a little problematic because trading online cuts the commissions, reduces

9. Brad M. Barber & Terrance Odean, *Online Investors: Do the Slow Die First?*, 15 REV. FIN. STUD. (forthcoming March 2002).

10. *See id.*

11. *See id.*

transaction costs, and makes it easier for you to achieve your rational ends. Those who went into online trading early were mostly men between the ages of eighteen and thirty. The online traders grossly underperformed both their own performance prior to moving online and the performance of men in the same demographics—same age, same wealth, same education, same everything—who had not made the switch. So, there are numerous studies out there finding these huge pockets of apparent irrationality in the financial markets.[12]

DAVID VAN ZANDT: I guess the problem really is defining "rationality" because on that theory racetracks or gambling parlors shouldn't exist. I'm a strong believer that the important point is that the institutional structure in which you decide whether something is rational or not can vary and therefore things that look rational in one context are not so rational in other contexts. But it's a definitional game; you're going back and forth. The other thing to say about it is this. Let's take day trading: within the institutional context and the information people were getting at the time they made their decisions, they probably were acting quite rationally until they updated their predictions about what happened. You don't see a lot of day traders right now because it is not a rational strategy. Sure, many people did act irrationally, but if irrationality was widespread, there would still be a day-trading market. This is Gary Becker's point about long-term rationality. There's a lot of behavioral psychology that talks about irrationalities such as when people are more likely to try to avoid a loss than take an opportunity for gain, if I have that right. But it's an asymmetry. If you look at markets over the long haul, and where there are institutional mechanisms to arbitrage, then I think those things disappear. There are some behavioral finance people like Robert Shiller[13]—and I'm not up on exactly where he thinks the difference is, but it strikes me as a lot of the examples we're talking about really depend largely on how you define what rationality is in a particular institutional context.

12. *See, e.g.*, RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 180–81 (1993) (defining some biases relevant to investor behavior such as the endowment effect, loss aversion, insensitivity to small probabilities, cognitive dissonance, and self-confidence); Daniel Kahneman et al., *The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSP. 193 (1991); Amos Tversky & Daniel Kahneman, *Loss Aversion in Riskless Choice: A Reference-Dependant Model*, 106 Q.J. ECON. 1039 (1991); Barber & Odean, *supra* note 9.

13. *See generally* ROBERT J. SHILLER, MARKET VOLATILITY (1992); ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (2001).

LEE BUCHHEIT: It seems to me the ability to rationalize after the fact does not mean that you acted rationally during the fact. We can all rationalize. Let's take a business negotiation. The fellow sitting on the other side of the table understands your position—perhaps even agrees with it in an intellectual sense—but nevertheless decides not to close the deal. It is quite possible that the other party has simply concluded, "I don't trust you. I believe the arithmetic, but," to pick up on something that our colleagues said this morning,[14] "my gut tells me you are not the kind of people I want to do business with. This guy wears French cuffs, and I'm a button-down kind of guy." In other words, in the broadest sense, "acting rationally" may involve an element of gut or emotion or intuition. These elements can be identified later in an ex post rationalization of why I made the decision I did.

DAVID VAN ZANDT: But I would say that's rational ex ante.

LEE BUCHHEIT: Perhaps so.

DAVID VAN ZANDT: You know, sometimes the only and best information you have is that you believe he's wearing the wrong cufflinks, which you believe is a signal that you should not trust the guy no matter what the numbers say. That's your best information and that's acting very rationally. What would be irrational in that context would be to go forward with the deal.

LEE BUCHHEIT: Yes. Wasn't it Clarence Darrow who said, "I don't like shredded wheat and I don't like anybody that does"?

ROBIN ENGELSON: I think, David, your point about what is the definition of "rational" is critical here because it's not particularly rational that a company that could borrow at four times its cash flow a year ago, or eighteen months ago, today can only borrow three times its cash flow from a senior lender. So, a company that had not otherwise experienced any change and still had $100 million in cash flow could borrow $400 million last year, and today that company is lucky if it can borrow $300 million (the senior credit markets are still reducing their leverage tolerances). So, there's nothing particularly rational about that other than the lenders doing that in the credit markets are doing it in concert with one another. One institution can't lend $400 million while another institution would only lend $300 million because it has to be accepted by enough other lenders in order

14. *See* Tamar Frankel, *Of Theory and Practice*, 77 CHI.-KENT L. REV. 5 (2001).

for the transaction to be completed or to "clear market." A $300 million transaction would likely have more than a dozen lenders.

JOHN COATES: So, this would be a way in which individual rationality can nevertheless produce collective irrationality.

ROBIN ENGELSON: It's the "lemming effect."

JOHN COATES: OK, the "lemming effect." I'll make one point about some of David's comments. I think the analogy of the racetrack unfairly suggests that these online traders were changing the way they thought about what they're doing from investing to betting. When they bet at the racetrack, they know they are probably going to lose on average, so they're doing it for consumption; they're doing it for fun. This analogy suggests that the fact that they all lost tons of money when they went online just means they were having fun. There are some problems with that theory or that rationalization of their behavior. One, I don't think many of the online traders would agree that that's what they thought they were doing; they were not just there to burn money. And two, the amount of money individuals have in their savings that can be burned up in this way is vastly different. So, it's possible that you might have the extreme gamblers out there, but—

DAVID VAN ZANDT: That wasn't my point, though. My point was not that the day traders are like gamblers. That's been made in the popular press. No, my point was that the definition of rationality depends a lot on the institutional structure in which you are acting. And you're absolutely right. By the way, there are some gamblers who think they're going to win, but hopefully most gamblers are there for the entertainment value, and they know they're going to spend a certain amount of money, and that makes that a highly rational kind of behavior. If you said only, "I'm going to look at the return on investment from gambling," if you took that lens, use that definition of rationality, then it's completely irrational to spend time doing it. My point wasn't that day traders are identical to gamblers; it was that it depends on the institutional context and your definition of rationality as to whether or not it is rational. We throw this word around, and we've got to be precise about our definitions.

LEE BUCHHEIT: Isn't the purer example of completely irrational commercial behavior a state lottery? There's no entertainment value in the state lottery. It's like tech stocks: "Hey, ya' never know!"

JOHN COATES: Let me give you an even purer example of irrationality. When 3Com Corporation announced that it was going to spin off Palm, Inc., it sold a portion of the Palm stock to the public before it completed the spin-off.[15] So, you could get Palm stock in one of two ways: you could buy Palm stock directly on the market, or you could buy 3Com stock and know that when the record date for the dividend of the subsidiary stock occurred you were going to get Palm stock in the future. The market, for over seven months, differently priced those two stocks to the tune of roughly $3 billion between the two. Now, there's a great paper by Thaler (at the "other" Chicago school) that explores why this discrepancy could persist for as long as it did.[16] Part of the reason is that it is very difficult to short stock. It's much more difficult to short stock than most people appreciate. First, you've got to find somebody to lend you the stock so you can do the shorting, and there is only a small number of institutions that engage in that sort of practice. So, only a very small subset of the overall float is available for shorting. Second, there are legal restrictions on shorting and so forth. Third, there is a limited number of people willing to take the risk involved in setting up the shorts to begin with. It seems, thus, that the arbitrage that we normally think of as being possible—the ability of people to intervene in the markets in correcting mispricings—is far from being unlimited, and is actually quite small. In this case, it apparently was less than $3 billion.[17]

And, where did this mispricing arise to begin with? Why in the world did people who were directly buying into Palm stock so overvalue the company, or, conversely, why did the people buying 3Com stock so undervalue the stock? One of the two groups must have been wrong in an egregious fashion for a long period of time. Do you have any reactions to that anecdote? Are the markets behaving rationally consistently over time?

DAVID VAN ZANDT: Over time, they generally are quite efficient—quite rational, quite efficient.

JOHN COATES: So, it all becomes a question of how rational, which I think is fair.

15. Floyd Norris & Lawrence M. Fisher, *Offspring Outweighs Parent As Offering Hits the Market*, N.Y. TIMES, Mar. 3, 2000, at A1; Seth Schiesel, *3Com Plans to Spin Off Its Palm Unit*, N.Y. TIMES, Sept. 14, 1999, at C1.

16. OWEN A. LAMONT & RICHARD H. THALER, CAN THE MARKET ADD AND SUBTRACT? MISPRICING IN TECH STOCK CARVE-OUTS (Nat'l Bureau of Econ. Research, Working Paper No. W8302, 2001).

17. *See id.* at 5.

REPUTATION

JOHN COATES: One last area that I want to talk about is reputation, and then we'll take questions and talk a little bit about how theory could be more useful to practitioners. Reputation is something I alluded to in my talk, but it is one aspect of practice where I think academics can learn a lot from practitioners. To what extent does the other person's reputation matter to you when you do business, and how do you go about finding out about reputation? Or, do people's reputations sometimes not match your experience of their behavior? Any reactions to that? Robin, do you make character loans?

ROBIN ENGELSON: Every loan is a character loan. And the only loans I've ever had trouble with are the ones where there was bad character.

JOHN COATES: Bad character that you knew about ahead of time?

ROBIN ENGELSON: No, except in one particular instance where, actually not related to the business that the fellow was in, he had a prior legal issue which he exposed and greatly apologized for and talked about how he was "recovered," so to speak. And based on the fact that the prior problem really wasn't particularly in a business context, we gave him the chance to redeem himself, and made the loan. It turned out that the behavior repeated itself later on. We were fine in the end, but the aggravation was certainly not worth having taken the chance.

JOHN COATES: So, reputation matters intensely, and your one out-of-equilibrium experience suggests you'll never do that again. How do you get information about another person's reputation? What do you do as a lender (other than interrogating others about their past, which is sort of a direct, one-on-one way)? Are these trade secrets?

ROBIN ENGELSON: It's a tough question. I think a lot of it is your—as I think Tamar would appreciate—"gut."[18] Some of it is observation, and some of it is past reputation, but it varies where you find that. And depending upon the size of the company and whether it's public or private, there are other sources you can use to validate that, such as ratings and analyst views and web-based research and all those sorts of things.

18. *See* Frankel, *supra* note 14, at 16–24.

LARRY ISAACSON: My view about how much people care about the character of their transacting partners is a bit different. I've seen clients that have had failed trades, and they want to sue their customer. They hire lawyers and do everything to prepare for litigation, and then the suit ultimately gets dropped. And I say to myself, "Well, that animosity will last only until the client calls for another trade." And, of course, the clients say they'll never do business with that customer again and then three months later they want to do a deal again with the same exact customer. That's exactly what I would expect in the investment banking communities. I think it's somewhat similar to what you see in the sovereign debt community, where a country defaults but banks come back to the table and make new loans to the country. In the lending context, in Robin Engelson's business, character probably matters more.

LEE BUCHHEIT: I think individual reputation is very important. Most lawyers are jealous of their reputation for competence, honesty, fairness, and the ability to get the deal done. And the litmus test comes, as it does sometimes, when a client wants you to tell a lie to a counterparty, or at least not to tell them the truth. A lawyer's instinct says, "No, I'm not going to do that because long after you, Mr. Client, are gone, the damage to my professional reputation will linger." And, therefore, individuals, whether business people or professionals, are usually very jealous of their reputation. This acts to curb some forms of outrageous behavior.

LARRY ISAACSON: I agree with you. I relish the opportunity sometimes—though I don't use it all the time—to tell a client "no" because I find that I generally get more respect after I've done that. There are a lot of other practitioners who wouldn't have the nerve to be forceful and tell someone "no" in those contexts.

JOHN COATES: All of you are sometimes agents and sometimes clients. When you're a client, how do you go about trying to assess the reputation of a person you're about to hire—say, a lawyer that you're about to retain? I wonder how easy it is for subsequent clients really to find out about those things. If a lawyer has committed legal violations and been arrested for drug use, that's one thing. But we're talking now about sharp practice, lying that doesn't rise to the level actionable fraud, general shady behavior, withholding information in situations where you know it would change the other person's view of the deal, and those sorts of things. I gather that avoiding such things is really what you mean by protecting your reputation. How do you find out whether the other side has done such things in the past? Do people have a sense of "word of mouth"?

LARRY ISAACSON: If they change lawyers a lot, if I see they've gone from law firm to law firm to law firm, I'm pretty suspicious about what's going on.

JOHN COATES: Oh, I see. Worrying about the client?

LARRY ISAACSON: Yes. First the client used Cleary, Gottlieb, Steen & Hamilton, and then used Fried, Frank, Harris, Shriver & Jacobson, and then used someone else; the client keeps trading in different lawyers. The client is either shopping for opinions or their lawyers have dropped them as clients.

LEE BUCHHEIT: Yes, or there's a trail of unpaid bills behind them.

DAVID VAN ZANDT: That's sharp practice.

GARY FUNDERLICH: There are two things that I do when looking to engage outside counsel. First, I have a trusted circle of outside counsel that I work with regularly, and if I need to go outside of that circle—and those people, by the way, have either come through referral or a trusted source—I survey them for suggestions or opinions. It's fairly easy in Toronto because there's not a very large community, so I can get good feedback in that regard. Secondly, I actually have an interview. It's amazing because if you sit down and talk about various scenarios, you get a feel for how the person conducts their business, how they view their practice, and how they are likely to conduct themselves with your business. I think if you spend the time and you use your best interviewing skills you can get a good feel for somebody. You're never going to be 100 percent certain.

JOHN COATES: So, this is the "gut" point, really. Interestingly, the emphasis is not really so much on reputation because here you're not directly relying on third parties, although you mentioned that, too. But you're really relying on your own ability to learn something directly from the other person's behavior.

One last question: If you consider reputation as being on a sliding scale from really evil to really angelic, do you ever want to work with someone who's towards the evil end? Are there certain circumstances when you would rather have somebody who is more willing to do things that a large group of people surveyed might say constitutes unfair or incorrect behavior in some general social sense? I'm thinking in particular about when you are hiring litigators (maybe as a transactional lawyer I have a certain bias). Do you really want the nice guy in the courtroom?

GARY FUNDERLICH: It depends on the circumstances. If you are talking about one of the relationships that perhaps Claire Hill was talking about in her paper,[19] where you are really looking to either reopen or continue the information flow, and you're looking for a longer relationship, I think what you look for is somebody who is simply a decent practitioner. If you are confronted by a firm or individual who is aggressive or plays on the margin, you may want someone who understands those sorts of behaviors, can anticipate them, and has a reputation for being able to operate the same way. I do think there are situations where you may want to look to the darker side of the continuum you described, but it really depends on the circumstances and where you want to come out at the end of the litigation or the claim.

DAVID VAN ZANDT: I don't think we should conflate civility, which is partly what you're talking about, with ethical behavior because I think there's a big difference between the two. It's clear that in the market for litigators, and even to some extent transactional lawyers, people specialize along different points on the civility line. Now, obviously the courts are concerned about this, and the bar is concerned about it. But there are situations where you do want a litigator who is very good at coming in and trying to really scare and really beat up on the other side. It's probably not a lot of situations. But I don't think we should equate that with unethical behavior. They develop a reputation, and if their service to their client is good and otherwise ethical, I don't think we should criticize people for that.

LEE BUCHHEIT: I think the difference is this: You hire a corporate lawyer to negotiate a transaction for you; that is almost by definition the beginning of a business relationship between the two principals. Litigation, however, is the end of a business relationship. A corporate lawyer's behavior, in the context of the negotiation, reflects upon his or her client. And if the corporate lawyer comes across as grasping, gratuitously aggressive, or uncreative or unreasonable, all of that can poison the business relationship that their client and the other party are about to enter into. Sometimes you walk out of a negotiating room and your client says, "When this

19. *See* Claire A. Hill, *A Comment on Language and Norms in Complex Business Contracting*, 77 CHI.-KENT L. REV. 29 (2001).

transaction ends I don't ever want to ever see these people again." If that disappointment is caused by the behavior of the other side's lawyer during the negotiations, has that lawyer really helped his client? On the other hand, if you're at the litigation stage, you're probably not looking forward to a bright future with the other side. For that reason, you're prepared to tolerate a little more of the gladiatorial instinct in your counsel.

ROBIN ENGELSON: And I guess I would just add to that that many borrowers will consider which lender to pick based on what lawyer they're going to use to document the loan. And it's not a function of being evil or not being evil, but being simple and straightforward and getting the communication out there that needs to be out there, without a lot of excess semicolons and commas.

DAVID VAN ZANDT: Particularly since the borrower is paying for their lawyer, which always griped me. It is not a well-designed incentive system.

QUESTIONS

JOHN COATES: Do we have any questions from the audience?

QUESTIONER ONE: Yes. SEC Regulation FD in essence prohibits disclosure of nonpublic material information to analysts that isn't disclosed to the market.[20] My concern with this when it was enacted by the SEC was that it would cut off the flow of information to the market and lead to stock volatility. I've seen some increased volatility after the regulation actually went into effect. What is the general consensus on the panel about that?

DAVID VAN ZANDT: I think I just saw a study that actually had tested that and saw no increase in volatility, though it's a short time period still.[21]

QUESTIONER ONE: Yes, there is one study suggesting that there is no increase in volatility, but from the sample size it's not entirely clear.

JOHN COATES: Does anybody here deal with the stock market and analysts enough to have a view on this? No, probably not.

20. SEC Regulation FD, 17 C.F.R. § 243 (2000).

21. *See* John Labate, *Disclosure Rule Has Not Fuelled Market Volatility*, FIN. TIMES (LONDON), March 19, 2001, The Americas, at 6, *available at* http://www.ccbn.com/regulationfd/20010319.html (citing an SEC study that suggested SEC Regulation FD has not led to an increase in stock market volatility).

QUESTIONER TWO: This question is for Lee and Larry because I know Lee deals with this and Larry I think has. Lee, you talked about persuading people to lend money or make some kind of accommodation when they've been shafted in the past. In a way, that story creates a new good reputation in a vacuum. And Larry, I know that you have all these parties that are in some kind of loose web in which they're all doing business with each other again and again. If you are a new sovereign who wants to redeem himself or a new entrant in the business, is there any kind of shorthand to gaining credibility other than hiring the likes of you? Usually one thinks of getting a good reputation, but this takes time. I'm just wondering whether there are techniques, and maybe it is just hiring one of you.

LARRY ISAACSON: My practice is very lawyer driven. New entrants hire me precisely because I've done sixty of the same deals in the last four years. It's the easiest way in which clients can get credibility because they're willing to pay expensive lawyers to do the deals and the clients know that the lawyers can enhance the clients' reputations. I think that is one way to do it. The other way is to do just the kinds of things you would expect: work hard and use clever and interesting ways to develop relationships and not just do what other banks are doing. It's not easy. The easiest way to jump-start it—I know this sounds self-serving—is to hire a lawyer. And I try not to use precedents from one client to the next. So, for each new client I have to get all my resources together and try to craft a new way to do the same old thing.

QUESTIONER TWO: Could a new lawyer enter into this business and it would be the same kind of thing?

LARRY ISAACSON: It's hard. I think I now get the same kind of work because we've done it before. The new lawyers getting into the business that I've been doing are trying to do exactly what you would expect: they're trying to compete on costs or compete in other ways. Fortunately, that's not been too successful.

LEE BUCHHEIT: I'll answer from the sovereign standpoint. Sovereigns have the charming characteristic that governments change—either constitutionally or extraconstitutionally—from time to time. If a prior government had imprudent economic or financial policies, they can sometimes be disowned by a successor government. Sometimes the secret is knowing when to confess one's sins. Public contrition can occasionally disarm one's critics. And then you move on to say, "We've learned our lessons. Ruritania is now creditworthy, and trust us, the regrettable things that happened to those other investors will never happen to you." Sometimes the job is knowing when and how to disarm legitimate criticism and present oneself as being different from the authors of some prior unpleasantry.

QUESTIONER THREE: To what extent does someone's attempt to ingratiate himself or herself impact your desire to make a loan?

ROBIN ENGELSON: Well, I guess that the biggest issue for all of us is that if throughout a career we're associated with people who are either intentionally or unintentionally not successful, that impacts us. And so it's incumbent upon all of us to make sure that we're taking on either clients or loans or acquisition targets or whatever where the value of the information or the underlying integrity is intact.

LARRY ISAACSON: But I thought you would say it's the reverse: not that being nice gets the person the loan, but that doing things that antagonize the lender means the person will not get the loan.

ROBIN ENGELSON: Well, I didn't say being nice gets the loan.

LARRY ISAACSON: Right.

LEE BUCHHEIT: Yes, I don't think charm alone can get you a loan from an institutional lender. Does a borrower try to put up a presentable individual to negotiate the loan? Absolutely. And do they try to bond with their counterparts? Absolutely. If they didn't, half the golf courses in the country would close. But I imagine there is a point at which it is possible to be too slick, and to come across as too shallow or facile, and trigger what you call the "gut reaction," the instinct that says the person in front of me may be more flash than substance.

QUESTIONER FOUR: I think John Coates alluded to something when he was talking about takeover defenses: when he asked his clients, they really didn't seem to care, or that if you look across the board, people were indifferent about what you did, whether you used takeover defenses or not.[22] As lawyers, I think we tend to find distinctions in our wording. And as Claire Hill talked about, she said she did a small sampling and she thought that, yes, these words are very different.[23] My question is, would you as business people accept that, or do you think that the numbers really are what the numbers are in a takeover, for example? And whatever these theories are that are either coming from academia or that have been somehow

22. John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001).

23. *See* Hill, *supra* note 19, at 52 n.54.

ingrained in practice, do they affect your business, or are they irrelevant? So, is a lawyer just someone that you need to go through but doesn't necessarily add value to your transaction?

JOHN COATES: Does law matter?

ROBIN ENGELSON: Oh, I think there are tremendous economic differences that result from the documentation of a transaction one way or another, though that doesn't refute the fact that it's not a nuisance that you have to go through the process.

DAVID VAN ZANDT: I would say that I don't think it's either/or. I'm agreeing: I think there are some parts of the document that are extremely important to the economics of the deal. There probably are some other parts of it that lawyers spend time on and clients don't stop them because it's not worth the clients' monitoring costs to stop it, but probably at the end it doesn't make an economic difference. But I don't think it's either black or white. John's data[24] is very interesting, and one hypothesis might be that takeover defenses are irrelevant in this context because, as somebody suggested, they're dwarfed by all sorts of other things. You know, we don't have the studies yet of whether or not IPOs [(initial public offerings)] really do have different pricing depending upon takeover defenses. It could be something that doesn't make a whole lot of difference to the economics of a deal, but also it's costly for clients to monitor their lawyers and stop wasteful practices. So, they're going to go let the lawyers go ahead and argue about a few of those things if it doesn't really impact them economically.

QUESTIONER FOUR: Robin, can you explain how your document can change economically?

ROBIN ENGELSON: From the lender's perspective or the borrower's perspective?

QUESTIONER FOUR: Well, there obviously are key terms. But I don't know if those are things that a lawyer would bring to the table or to the document versus what you as a businessperson are going to negotiate on either side. So, when you say that a lawyer can really change the economic value of a document from either side, I guess, I'm just curious in practice how that works?

ROBIN ENGELSON: Well, I guess in practice, going to some of the comments that Claire Hill made earlier,[25] the remedies section of the

24. Coates, *supra* note 22.

25. *See* Hill, *supra* note 19, at 45–51.

document, depending upon how that's documented, can lead to different actions when it comes time for those remedies to be exercised. Of course, that's the time at which a lot of the ex ante, if you will, economic value is determined. Another factor that can affect the economic value of a transaction is how well that transaction was documented: who was protected, what their rights were, who gets to do what when, which assets belong to whom and for how long, and the other issues that come into play there.

LARRY ISAACSON: I think that viewing lawyering as documenting is the problem. I think that the reason I'm hired, to some extent, is because I'm second-guessing my own clients' decisions or participating in those decisions with my clients. I'm not just documenting, I'm also thinking about the same business issues that they're thinking about. And that is really where, to a large extent, I add value.

I had a client that for four years has been marketing managed pools of bonds and selling securities based on these managed pools of bonds. They sold these managed pools of bonds by touting all the virtues and effects of management. Recently, they sent me a term sheet to do a deal that was a static pool, which basically would be exactly the same as what they had been selling—the managed pools—but without management. I assume they had analyzed the economics from an arbitrage perspective. During a conference call, I noted, "I assume you've considered that if this deal is successful, or in fact more successful than your managed deals, then the markets will perceive that all you've been saying about management wasn't true." There was just dead silence on the other end of the line. I haven't heard from that client in a couple of weeks.

JOHN COATES: I think that's a great note on which to break. It's been a fascinating discussion.