Encountering the Scarlet Woman of Wall Street: Speculative Comments at the End of the Century

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How does a country achieve a public capital market in which firms can raise capital from investors? In seeking clues and hypotheses, this article looks back to the dawn of the public corporation in the United States. The battles for control of the Erie Railroad, known as the "Scarlet Woman of Wall Street," a reference to its ill repute, stand at the symbolic center of these developments.

The battles for control, which waxed and waned between 1868 and 1872, involved: the titan of the transportation age, Cornelius Vanderbilt; the brilliant and notorious stock market manipulator and takeover entrepreneur, Jay Gould; the largest and most powerful railroad of the era, the Pennsylvania; control over rail transportation to New York City; and the politics and courts of New York, Pennsylvania, and Ohio. It was played out in the securities markets, the courts, the legislatures, and the newspapers and attracted the attention, and condemnation, of some of the leading commentators of the day.

Rereading this history from the vantage point of the end of the twentieth century, several features are striking. First, the battles are remarkably familiar: they are recognizably modern battles for control over a widely-held corporation. Second, many of the tactics utilized are now illegal. Finally, surprising connections emerge between antitrust, federalism, and the emergence of public capital markets.

As we approach the end of the century, the political and economic development of the countries of the former Soviet Union, and especially

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Russia, stands high on the list of international priorities. Yet development has been stymied by large capital needs combined with massive manipulation, pervasive corruption, and the failure of the rule of law. In looking forward, it is worthwhile to look back. How does a country arrive at public capital markets in which firms can raise capital from investors?

In seeking clues and hypotheses, I look back to the dawn of the modern age in the United States, to the dawn of the public corporation. Economic development in the United States exploded after the end of the Civil War in 1865. The key project was the construction of a transportation infrastructure, that is, the railroads. Requiring enormous capital and involving substantial business risk, railroads were at the core of the developing public capital market. They were the original publicly-held corporations.[1]

But the post-Civil War period was also a time of manipulation, corruption, and failure of the rule of law, a time of boom and of bust. It was also the era of monopoly, of oil, steel, and other trusts. The battles for control of the Erie Railroad stand at the symbolic center of these developments.[2]

The Erie was one of the three principal rail lines serving New York City. Founded before the Civil War, it became known as the "Scarlet Woman of Wall Street," a reference to its ill-repute. Never very secure financially, its securities (both its shares and its bonds) were extremely volatile and long provided rich opportunities for manipulation. But at the same time, it was a strategic road, running west across New York State, terminating at the Great Lakes, and linking up with lines heading west to Chicago and beyond.

The battles for control, which waxed and waned between 1868 and 1872, involved a marvelous cast of characters: the titan of the transportation age, Cornelius Vanderbilt; the brilliant and notorious stock market manipulator and takeover entrepreneur, Jay Gould; the largest and most powerful railroad of the era, the Pennsylvania; control over rail transportation to New York City; and the politics and courts of New York, Pennsylvania, and Ohio. It was played out in the securities markets, the courts, the legislatures, and the newspapers and attracted the attention, and condemnation, of some of the leading commentators of the day. In particular, Charles Adams, Boston brahmin, grandson and great-grandson of presidents, and one of the founders of public utility regulation, made his name with his famous exposé in the pages of *The North American Review*, "A Chapter of Erie."[3]

1 *See generally* Walter Werner & Steven T. Smith, Wall Street 133-54 (1991).

2 On Gould and the Erie, see Charles F. Adams & Henry Adams, Chapter of Erie and Other Essays (1871; reprinted 1967); Julius Grodinsky, Jay Gould 1867-1892 (1957); John Steele Gordon, The Scarlet Woman of Wall Street (1988).

3 N. Am. Rev., July 1869.

Rereading this history from the vantage point of the end of the twentieth century, several features are striking. First, the battles are remarkably familiar: they are recognizably modern battles for control over a widely-held corporation. Second, many of the tactics utilized are now illegal. Finally, some surprising connections emerge.

In focusing on the late 1860s and early 1870s and comparing the legal infrastructure of today with that of the 1870s, I examine elements of the legal infrastructure that accompanied the move from the robber baron capitalism of the Gilded Age to the deepest and most attractive public capital market in the world at the end of the twentieth century. I do not claim to show that this legal infrastructure is either necessary or sufficient, but, rather, to suggest possible hypotheses and directions for further research.

I. THE ERIE WARS

In the enormous industrial expansion following the Civil War, railroads became the dominant mode of transportation. Because of the railroads' enormous capital requirements, they were the very first corporations with shares widely held by the investing public. Many of the investors were abroad, largely in England. The shares were actively traded on various exchanges, sometimes for investment, often for pure speculation.

Three railroads served New York City: the New York Central; the Pennsylvania; and the Erie. The New York Central was put together by the legendary Cornelius Vanderbilt and traversed New York State, serving its western regions, and arriving in New York City from the north.[4] The lines through the Hudson River valley — the Harlem and the Hudson River Railroads — once competitors of the New York Central, were brought under common control by Vanderbilt shortly after the end of the Civil War.

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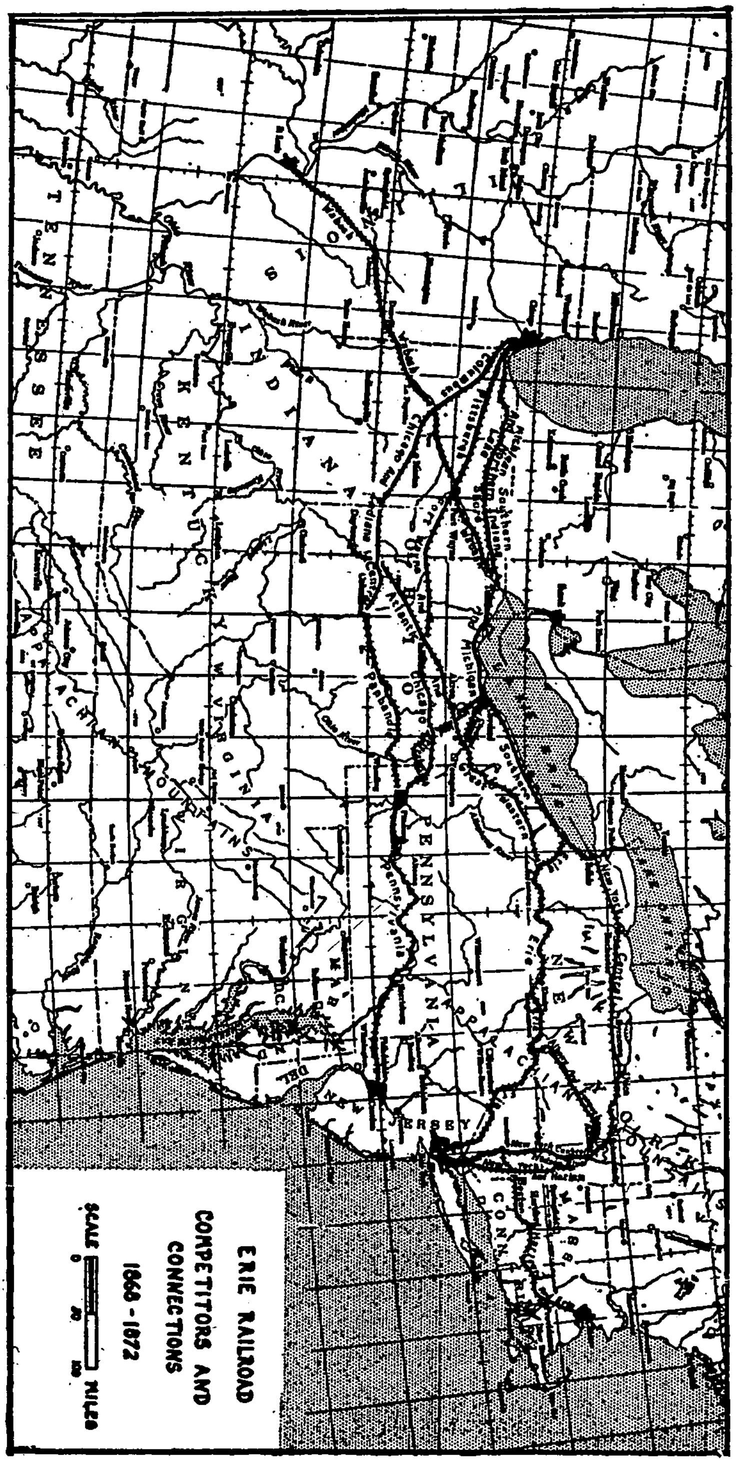
4 Grodinsky, *supra* note 2, at 68 fig. 1 (map of the Erie's service area).


ERIE RAILROAD
COMPETITORS AND
CONNECTIONS
1860 - 1872
SCALE 0 50 100 MILES
PENNSYLVANIA
INDIANA
KENTUCKY
OHIO
TENNESSEE
NEW JERSEY
APPALACHIAN MOUNTAINS

The Pennsylvania Railroad, then the most powerful railroad in the nation, served New York City from the south, through Pennsylvania and New Jersey, and dominated westward rail service.

The Erie, the weakest of the three, ran from New York City west across the state to Lake Erie, where it connected with lines to Cleveland, Toledo, and Chicago. In character, the Erie was a far less respectable railroad than either of its principal competitors. In what could have been — and eventually was — a very comfortable and profitable oligopoly, the Erie was often a disruptive force, triggering rate wars and the building of competing overlapping lines. The Erie's irresponsibility derived from two sources. First, because it was historically undercapitalized and mismanaged, it was far less financially stable than its competitors and periodically faced liquidity crises that pushed it to seek to increase its market share short term, even at the cost of triggering a rate war. Second, it had long been controlled by a group led by "Uncle" Daniel Drew (nicknamed the "speculative director" because of his insatiable appetite for stock manipulation) that was more interested in profiting by stock price movements (up or down) and self-dealing than by successful rail operations. The Erie's unpredictable behavior in the rail markets increased the volatility of its stock in the market, maximizing trading opportunities.

Because the Erie and the New York Central were the two principal lines crossing New York State, the Erie was a particularly troublesome thorn in the side of Vanderbilt's New York Central and an obstacle to his goal of controlling a dominant share of the New York City rail market.

A. Round One

In 1867, Vanderbilt, after taking control of the New York Central and the competing Hudson River lines, turned his attention to the Erie, the chief remaining competitive threat. His first attempt was to take control by electing a slate of sympathetic directors at the annual meeting. His goal was to form a rate pool among the Erie, the New York Central, and the Pennsylvania.

Three parties strove for control of the Erie Board, each more colorful than the next. The incumbent group was led by Drew, who had controlled the Erie since 1854.[5] The principal challenger was Vanderbilt's group, which, at times, was allied with the third group, comprised of Boston financiers who controlled the bankrupt Boston, Hartford, and Erie Railroad ("B, H & E"), a projected feeder and connection of the Erie. The B, H & E had obtained a

5 *Id.* at 28.

commitment of a subsidy from Massachusetts on condition that the Railroad raise additional capital on its own, a goal in which the Erie could substantially assist.

This first battle for control was carried on through the straightforward buying and selling of proxies. Shareholders were willing to sell their proxies to the highest bidder.[6] Eventually, Vanderbilt gained the upper hand, leading Drew to join forces with him.

As a result, Vanderbilt's slate of directors won the election. As part of Vanderbilt's coalition with Drew's forces and the Boston group, Jay Gould, until then a relatively unknown broker and shareholder of the Erie, was elected to the Board. In the weeks following the election, Eldridge, the leader of the Boston group, became President, and with Gould's support, the Erie agreed to guarantee interest of $4 million on the B, H & E's bonds.[7]

When Vanderbilt then moved to exercise the control he thought he had achieved over the Erie, he encountered opposition. To his surprise, the Erie Board members, under the influence of Gould, fought for the Erie's share of the returns from the proposed rate pool and fought hard enough to lead to a breakdown in the negotiations.[8] Gould's and Drew's alliance with Eldridge and the Boston group apparently undermined Vanderbilt's control. In the wake of this breakdown, the Erie, New York Central, and Pennsylvania seemed to be heading towards a rate war. This was Gould's public debut in the struggles for control over railroads, an arena in which he continued to play a central role for the rest of his career.

It was at this point that the second and greater battle began.

B. Round Two

Vanderbilt, frustrated with his inability to gain control over the Erie through purchasing proxies, decided instead to acquire control by purchasing a majority of the Erie stock, a method he had used with success in taking control of the Hudson River Railroad.

To understand the difficulties facing Vanderbilt in pursuing this strategy, one must return to a particularly ingenious bit of manipulation that Drew pulled off during the spring of 1866. In the face of one of the Erie's periodic financial crises, Drew, the Erie Treasurer, lent $3.5 million of his own money to the Railroad and took as collateral 28,000 unissued shares and bonds

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6 Adams, *supra* note 2, at 14.
7 Grodinsky, *supra* note 2, at 39.
8 *Id.*

for $3 million, convertible into stock. Drew then went short on Erie as the price rose. "Erie was scarce, the great bear had many contracts to fulfill, and where was he to find the stock?"[9] Drew laid his hands on the collateral, converted the bonds into an equivalent amount of capital stock, and dumped 58,000 shares of Erie stock on the market, thereby driving down the price from $95 to $50 and making a killing.

The critical legal detail here, elaborated on below, is that while under New York law, the issuance of stock required the approval of two-thirds of the shareholders, the issuance of bonds convertible into stock did not.[10]

Vanderbilt, in his quest for control of the Erie, was aware of this feature and thus faced a particular challenge. It was "very necessary for Vanderbilt that he should, while buying Erie with one hand in Wall Street, with the other close, so far as he could, that apparently inexhaustible spring from which such generous supplies of new stock were wont to flow."[11] So long as the incumbents at the Erie could continue to manufacture new shares, Vanderbilt would be unable to gain control and would, in fact, simply be strengthening the Erie by allowing it to raise additional capital at low cost.

This led to what, to contemporary chroniclers, particularly Charles Adams, was the most discreditable chapter of the story: the issuing of competing and contradictory injunctions by different New York judges at the behest of the contending parties, apparently in exchange for bribes. The possibility of simultaneous and inconsistent injunctions arose out of a peculiarity of the New York judicial structure at the time: it divided the state into eight distinct districts, each of which had an independent supreme court with four or, in the case of New York City, five judges, elected by the citizens of that district.[12] These local judges had the equitable power to grant injunctions that would apply throughout the state.[13] Thus, unless individual judges demonstrated substantial restraint — which they did not in this case — conflicts among districts were inevitable.

Faced with Vanderbilt's attempt to buy a controlling interest, with injunctions restraining the Erie from issuing additional shares, the incumbent group of Drew, Gould, and Fisk found agreeable judges in other districts to issue conflicting injunctions. The Gould group ignored the injunctions granted Vanderbilt and manipulated corporate processes to delegate power to issue stock and bonds to an executive committee they controlled, all of

9 Adams, *supra* note 2, at 7.
10 Grodinsky, *supra* note 2, at 41.
11 Adams, *supra* note 2, at 18.
12 *Id.* at 22.
13 *Id.*

which culminated in the sale of thousands of new Erie shares precisely at the time when Vanderbilt was driving up the price by trying to buy control. Despite the variety of competing injunctions, the Gould group succeeded in floating enough additional Erie shares so that by March 11, 1867, Vanderbilt had absorbed 100,000 shares of Erie, at prices ranging between $71 and $83, without acquiring a controlling interest (prior to the stock issues, there were around 250,000 shares outstanding).

This flouting of injunctions led to one of the more colorful financial moves of the period. Hearing that contempt proceedings were in process, the principal Erie executives fled from Manhattan to Jersey City, one step ahead of the police, with bales of greenbacks ($6 million by one estimate) and crates of documents. This assured that the Erie could continue operating regardless of events in New York.

The battle then shifted to the legislatures. First, as a defensive measure, the Erie pushed a bill through the New Jersey Legislature to make it a New Jersey corporation with the same powers that it enjoyed in New York.

Then, in New York, the Erie forces sought *ex post* legislative validation of their defensive tactics (and, while they were at it, to erect a barrier to Vanderbilt's bid) by introducing a bill "in the NY assembly legalizing the recent issue of new stock, declaring and regulating the power of issuing convertible bonds ... and finally forbidding, in so far as any legislation could forbid, the consolidation of the Central and the Erie in the hands of Vanderbilt."[14] But Vanderbilt had enormous political strength, and the measure was defeated in the Legislature by a vote of 83-32 on March 27, 1867.

Thereupon, on March 30, Gould, still subject to arrest in New York for contempt, departed for Albany with $500,000 of Erie cash. Within three weeks of his arrival in Albany, he had distributed massive bribes, which reversed the legislative outcome. Both the New York Senate and Assembly passed a bill that was, for all intents and purposes, identical to the bill defeated earlier. Vanderbilt's opposition collapsed, and with hardly any delay, the Governor signed the legislation.

At this point, peace negotiations commenced between the two camps. By July 2, 1867, the parties had reached an agreement. The Erie repurchased 50,000 shares from Vanderbilt at $70 per share and, in addition, paid Vanderbilt $1 million for a four-month option to purchase his remaining shares, also at $70. The Erie repurchased $5 million of the Boston, Hartford, and Erie bonds from the Boston group for $4 million. Gould and Fisk

14 *Id.* at 48.

remained in control of the Erie.[15] As it happened, in the wake of this settlement, money was easy and the demand for Erie stock brisk, so that the Erie was able to resell the shares repurchased from Vanderbilt without a loss.[16]

Following Vanderbilt's defeat, the Erie control group teamed up with Tammany Hall, the ring that controlled politics and the courts in New York City and, subsequently, in New York State. At the Erie's next annual meeting, William ("Boss") Tweed and Peter Sweeney were elected to the Board. Although there were several subsequent skirmishes, primarily with the English shareholders, led by August Belmont (the Rothschild's man in New York), no one was a match for Gould and his Tammany Hall allies.

C. Round Three

Having taken control of the Erie, Gould set about consolidating his position and expanding his empire. His links with Tammany Hall allowed him to consolidate control. The Tammany-controlled New York State Legislature passed a bill classifying the Erie Board into five classes, with only one fifth of the directors up for election each year.[17] Gould had the gall to inform the Erie shareholders that this would "secure to the property a responsible, experienced and intelligent management, and be the means of preventing in the future the sudden changes in the policy of this magnificent railway, peculiar to it in the past while it was a mere creature of Wall Street speculation."[18]

This combination gave Gould almost complete control over the Erie, although he had little stock ownership. The classified Board meant that it would take years to supplant his nominees. With his Tammany Hall connections, he owned a judge, and supplemented by bribes to legislators, he could secure necessary legislation.

With his control of the Erie secure, Gould set about expanding westward by trying to link up with connecting lines that provided through-service to Chicago and points west. This led to a series of battles for control of the lines that fed traffic into the eastern trunk lines (the Pennsylvania, the New York Central, and the Erie). In particular, Gould's attempts to acquire exclusive control of the connecting lines transformed the prevailing practice

15 *Id.* at 58.
16 *Id.* at 61.
17 Grodinsky, *supra* note 2, at 71-72.
18 *Id.* at 71.

whereby the eastern trunk lines generally had relied on relatively informal arrangements and led to pitched battles for control.

The battle for the Fort Wayne provides an illustration. A large freight carrier, the Fort Wayne historically had had primary connections with the Pennsylvania. But the stock was widely held, with most of the shareholders in England. Knowing that the Erie did not have enough money to outbid the Pennsylvania in a battle for control, Gould turned, instead, to the proxy market and, by mid-February 1869, despite management opposition and warnings to shareholders, had managed to acquire enough proxies to ensure control of the Fort Wayne.

At this point, the Pennsylvania recognized the danger of losing its most valuable Chicago connection. For its part, incumbent management at the Fort Wayne had developed an antipathy for Gould from a prior battle. With Gould holding a majority of the proxies, the battle shifted to the Pennsylvania Legislature, where the Pennsylvania had enormous influence. Cass, the President of the Fort Wayne, pointed out that if Gould took control of the Fort Wayne, freight that traveled through Pennsylvania would be diverted to the Erie and end up in New York. Within thirty-four minutes, a bill providing for four classes of directors of the Fort Wayne, with election of one-quarter of the directors per year, was passed by both houses of the Pennsylvania Legislature and signed by the Governor.[19] Gould was thus defeated in his bid for control.

At around the same time, Gould and his allies acquired some control over the Wabash, another major through-road that would allow a through route between New York, Chicago, and the Mississippi River in competition with Vanderbilt's competing route.[20] By the summer of 1869, pressure built on Gould to increase traffic on the Wabash in order to increase its stock price, to persuade the Wabash shareholders to approve an alliance with the Erie, and to increase the traffic on the Erie. The most certain means of increasing traffic was to increase export demand for wheat, the primary commodity that flowed over the Wabash's lines. It was in order to increase this export flow that Gould demonstrated *chutzpah* of mind-boggling dimensions: he made a serious and nearly successful effort to corner the United States gold market.

The theory was that export wheat was paid for in gold. The more expensive gold became in dollars, the more wheat an ounce of gold would buy, and, thus, the cheaper wheat would become for foreign buyers who bought with gold. Gould's spectacular but ultimately unsuccessful attempt to corner the

19 *Id.* at 65.
20 *Id.* at 73.

gold market — and the crash that followed upon his failure — is a long and fascinating story in its own right.[21] The most interesting part of it, for our purposes, is how it played into both Gould's manipulations in Wabash stock as well as his attempts to increase freight flows on the Erie.

In the panic that followed the collapse of the gold speculation in September 1869, the proposed consolidation of the Wabash with the intervening road, the Lake Shore, was rejected by Lake Shore shareholders, an important victory for Vanderbilt and the New York Central. This was a disaster for the Erie. It now had no connections west of Buffalo.

Gould continued to struggle for western connections and to improve the state of the Erie, but whatever progress he made was hampered by his constant self-dealing. Almost reflexively, it seems, he searched for opportunities to line his own pockets. By the end of 1871, the Erie was a wreck, Gould's Tammany Hall friends had lost control of the New York Legislature, and his pet judge had been ousted.

By this point, the long-suffering English shareholders had organized and hired counsel to represent their interests. The Atlantic & Great Western Railroad, a connecting line, was likewise working to oust Gould in order to further the Atlantic's interests.[22] The Erie was on the verge of financial collapse. Finally, Gould and his board resigned (but only after being paid to do so out of Erie funds).

Following this resignation, there was enormous speculation in Erie stock, both by the victors and the vanquished, with Gould apparently profiting by $3.25 million. Finally, again after significant machinations, Gould and the new Erie Board settled the Erie's claims against Gould in return for securities and other consideration that turned out not to be worth very much.

D. Gould's Later Life

After leaving the Erie a rich man in 1872, Gould continued in the railroad industry and, by that autumn, had acquired control of the Union Pacific. Using that as a base, he finally assembled a transcontinental railroad. In expanding his empire, he was sometimes a competitive force, triggering rate wars, and sometimes a monopolizer. In acquiring and expanding roads, he destabilized the industry, forced innovation and restructuring, and

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21 *See, e.g.*, Kenneth D. Ackerman, The Gold Ring: Jim Fisk, Jay Gould, and Black Friday 1869 (1988).

22 Grodinsky, *supra* note 2, at 97.

undermined cartels. Throughout, he was an enthusiastic market operator, dying in 1892 an exceedingly rich man.

II. Gould, Vanderbilt, and Our Contemporary Regulatory Environment: A Quick Overview

The Erie wars were a representative, if perhaps extreme, example of the practices of the day. Gould, to be sure, was reviled. But others, even the most respectable, engaged in many of the same practices, albeit perhaps without his tireless (and rather engaging) enthusiasm. In aggregate, these practices (rightly) should have made small investors wary of investing in the shares of Gould-controlled companies. Indeed, a prevalence of such practices might rightly make individual investors wary of investing in publicly-held companies at all, depending on the investment alternatives.

The Erie wars thus provide a useful benchmark for checking the main features of our current regulatory scheme. How do we now control the sort of abusive practices that characterized the Railroad Age? What provisions protect the individual shareholder from operators like Gould? Could a modern- day Gould pull these stunts today? It is to these questions that I now turn.

A. The Market for Proxies

1. State Law Limitations

From Gould's earliest forays, he — like his competitors — often turned to the market for proxies in order to gain corporate control. Vanderbilt originally took control of the Erie with purchased proxies; Gould acquired control of the Fort Wayne in the same way. Buying proxies was apparently so common during this period that there was a fairly well developed "market."

Today, buying proxies is illegal in New York. The New York statute provides that "[a] shareholder shall not sell his vote or issue a proxy to vote to any person for any sum of money or anything of value."[23]

For a long time, Delaware followed the same rule. Interestingly, however, in recent years, it has developed a more textured view of the sale of votes. In a series of cases, starting with *Schreiber v. Carney*,[24] the Delaware courts

23 N.Y. Bus. Corp. § 609(e) (CLS 1986). I do not know whether § 609(e) was passed in response to the nineteenth-century abuses.

24 447 A.2d 17 (Del. Ch. 1982).

abandoned the older per se condemnation of vote buying and recognized that situations may present themselves in which vote buying is in shareholders' interests. In the evolving Delaware jurisprudence, the key question is whether "the object or purpose is to defraud or in some way disenfranchise the other stockholders."[25] Rather than categorically prohibit the practice, the Court of Chancery now views the practice as "a voidable transaction subject to a test for intrinsic fairness."[26] Since *Schreiber*, the Delaware courts have elaborated on this basic view, applying it to both stock and bonds.[27] Even, however, under the more flexible modern Delaware approach, it is unlikely that Vanderbilt's, Gould's, and others' routine purchases of proxies as a (cheaper) alternative to gain control would have met the Delaware standard.

2. Federal Limitations

The current federal regulatory structure would have utterly transformed the dynamics of the control battle between Gould and Vanderbilt. Without giving a full overview, a number of points should be noted. First, both Gould and Vanderbilt would have had to comply with the federal proxy rules in connection with their solicitations of proxies (including their solicitations to buy proxies). Under the federal rules, Gould and Vanderbilt could not have solicited proxies "unless each person solicited is concurrently furnished or has previously been furnished with a publicly filed preliminary or definitive written proxy statement containing the information specified in Schedule 14A [of the Securities Exchange Act]."[28]

Schedule 14A requires, *inter alia*, that each contesting party identify all its participants (which includes any person who lends money or furnishes credit for the purpose of assisting the solicitation). All statements made, both in the written proxy statement as well as in the soliciting process itself, are subject to the prohibition on fraudulent or misleading statements under rule 14a-9.[29] These two provisions — assuming compliance — would have

25 *Id.* at 25-26.

26 *Id.* at 26.

27 For a summary of the Delaware approach, see Thomas J. Andre, Jr., *A Preliminary Inquiry into the Utility of Vote Buying in the Market for Corporate Control*, 63 S. Cal. L. Rev. 533, 545-51 (1990).

28 Securities Exchange Act, Rule 14a-3, 17 C.F.R. § 240.14a-3 (2000). That said, so long as neither furnished a form of proxy to security holders prior to furnishing each security holder with a written proxy statement, other solicitation is permitted, so long as the identity of participants and their interests are disclosed and a written proxy statement is furnished at the earliest practicable date. Rule 14a-11, 17 C.F.R. § 240.14a-11.

29 17 C.F.R. § 240.14a-9.

brought much of the backroom maneuvering out into the sunlight (although undoubtedly, it would have been replaced by other backroom maneuvering that would not have been necessary to disclose). The timing of the solicitation, which was critical, would likewise have been altered.

Moreover, Gould and Vanderbilt would both have had to comply with the disclosure requirements under section 13(d) of the Securities Exchange Act.[30] Under section 13(d), within ten days of becoming directly or indirectly the beneficial owner of more than 5% of a class of stock, one must disclose: the identity of all members of one's "group"; the identity and background of all people involved (including disclosure of criminal convictions with details); the source and amount of funds used in making the purchases; the purpose of the purchases; the number of shares owned, directly or indirectly; and information

> as to any contracts, arrangements, or understandings with any person with respect to any securities of the issuer, including but not limited to transfer of any of the securities, joint ventures, loan or option arrangements, puts or calls, guaranties of loans, guaranties against loss or guaranties of profits, division of losses or profits, or the giving or withholding of proxies, naming the persons with whom such contracts, arrangements, or understandings have been entered into, and giving the details thereof.[31]

Michael Milken's problems with the law stemmed, in part, from violations of these provisions. For example, Milken pleaded guilty to entering into an arrangement with Ivan Boesky to guarantee Boesky against loss in the shares of Fischbach, an arrangement that was not disclosed in Schedule 13-D forms. As Milken explained,

> In 1984, our department had purchased some securities of Fischbach, a company in which Victor Posner had an interest. Drexel had provided financing to several other companies which Mr. Posner had an interest in.
>
> In early 1984, Mr. Posner publicly announced that he intended to acquire Fischbach. Boesky was familiar with the Fischbach situation and wanted to purchase Fischbach securities. I encouraged him to do so. I do not remember exactly what I told him almost six years ago, but I indicated to him that he would not lose money.
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> The Boesky organization began buying Fischbach securities and

30 15 U.S.C. § 78m(d) (1994).

31 13(d)(1)(E), 15 U.S.C. § 78m(d)(1)(E) (1994).

eventually bought over 10 percent of Fischbach including securities that had been owned by Drexel. Over the next months, he called me incessantly to complain that the price of the stock was dropping, that Drexel was responsible for his losses, that my comments to him were guarantees against loss and that he expected us to make good.

I assured him that Drexel would make good on his losses. These assurances were not recorded on the books of Drexel and I did not expect that they would be reflected in any Schedule 13-D's filed by the Boesky organization, and, in fact they were not. Thus, I assisted in the failure to file an accurate 13-D. This was wrong and I accept responsibility for it. This is the basis for Count 2 and is one of the overt acts in Count 1.[32]

B. Vanderbilt's Takeover Attempt and Gould's Defensive Issuance of Stock

Recall that by issuing new shares as quickly as Vanderbilt was able to acquire them, Gould defeated Vanderbilt's Round Two attempt to acquire control of the Erie through buying a majority of its shares. To what extent could Gould have used this tactic today?

1. State Law Limitations

Gould's particular defensive tactic derived from a peculiar loophole in New York corporate law: while issuing new shares required a shareholder vote (possibly because it required amendment of the certificate of incorporation), issuing bonds convertible into shares did not. This raises two questions with regard to the current corporate scheme. The first is whether today the issuance of securities convertible into shares that go beyond those shares authorized in the certificate of incorporation will be effective.

This is a nice question. On the one hand, one can argue that the issuance of shares that are not authorized in the certificate of incorporation should be considered a legal nullity. Otherwise, what is the use of a certificate of incorporation?

On the other hand, the board of directors has apparent authority to issue shares and bonds convertible into shares, and as to innocent third parties, one might argue that such obligations should bind the corporation. This is

32 [Milken's] *Text of Statement to Court Describing 6 Felonies*, N.Y. Times, Apr. 25, 1990, at D8.

precisely the argument that was successful in the elimination of the *ultra vires* doctrine in U.S. corporate law. For example, Delaware GCL section 124 explicitly provides:

> No act of a corporation and no conveyance or transfer of real or personal property to or by a corporation shall be invalid by reason of the fact that the corporation was without capacity or power to do such act or to make or receive such conveyance or transfer, but such lack of capacity or power may be asserted:
>
> (1) In a proceeding by a stockholder against the corporation to enjoin the doing of any act or acts or the transfer of real or personal property by or to the corporation. If the unauthorized acts or transfer sought to be enjoined are being, or are to be, performed or made pursuant to any contract to which the corporation is a party, the court may, if all of the parties to the contract are parties to the proceeding and if it deems the same to be equitable, set aside and enjoin the performance of such contract, and in so doing may allow to the corporation or to the other parties to the contract, as the case may be, such compensation as may be equitable for the loss or damage sustained by any of them which may result from the action of the court in setting aside and enjoining the performance of such contract, but anticipated profits to be derived from the performance of the contract shall not be awarded by the court as a loss or damage sustained.[33]

The language of this statute thus suggests that if Gould could manage to get the shares issued — as he did — they would be valid. This is further supported by the Delaware case law holding that "the issuance of stock without consideration or for an insufficient consideration does not render the issue void, but voidable."[34]

As it happens, under Delaware law, the first argument prevails. Stock issued in violation of the certificate of incorporation is stock issued without authority of law and is, therefore, void and a nullity.[35]

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33 Del. Code Ann. Tit. 8, § 124 (1991).

34 Edward P. Welch & Andrew J. Turezyn, Folk on the Delaware General Corporation Law: Fundamentals § 152.5 (1993), *citing* Finch v. Warrior Cement Corp., 141 A. 54, 62 (Del. Ch. 1928), *rejecting dictum in* Ellis v. Penn Beef Co., 80 A. 666, 668 (Del. Ch. 1911), *and* Scully v. Auto. Fin. Co., 109 A. 49, 52 (Del. Ch. 1928), *and* Highlights for Children, Inc. v. Crown, 227 A.2d 118, 121-22 (Del. Ch. 1966).

35 Staar Surgical Co. v. Waggoner, 588 A.2d 1130, 1137 (Del. 1991); Triplex Shoe Co. v. Rice Hutchins, Inc., 152 A. 342 (Del. 1930).

But even if one were to adopt the "apparent authority" argument, Vanderbilt could have enjoined the conversion if he had managed to get the holders of the convertible bonds into court before the bonds were converted into shares. Alternatively, to the extent that the purchasers of the convertible bonds and the holders of the shares knew that they were not authorized, he might also have been able to convince a court to cancel them, not because cancellation is the exclusive remedy, but because it would have been the form of relief "most in accord with all the equities of the case."[36]

Finally, even if issuing such bonds were authorized by state corporate law, it would still be subject to attack as a breach of a fiduciary duty if done for pure entrenchment, as it was.[37] Indeed, that was the essence of the claim brought by Vanderbilt against Gould. The problem Vanderbilt had was that Gould ignored the injunction and, because of a quirk of New York law, was able to find a judge who would issue a counter-injunction.

2. Federal Law Limitations: Securities Law

Because Vanderbilt sought to acquire control by buying up the shares from whoever was willing to sell, he would have been subject to the Williams Act requirements governing tender offers, in addition to the requirements under section 13(d) described above. In particular, Vanderbilt could not have made a tender offer for Erie shares unless he had complied with the disclosure requirements under Regulations 14D and 14E. Moreover, he would have had to comply with other requirements, including: the timing requirement;[38]

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36 Blair v. F.H. Smith Co., 156 A. 207, 213 (Del. Ch. 1931), *quoted and cited in* Welch & Turezyn, *supra* note 34.

37 Welch & Turezyn, *supra* note 34, § 161.2; Can. S. Oils v. Manabi Exploration Co., 96 A.2d 810, 813 (Del. Ch. 1953); Condec Corp. v. Lunkenheimer Co., 230 A.2d 769, 775 (Del. Ch. 1967); Viele v. Devaney, 679 A.2d 993 (Del. Ch. 1996); WNH Invs. v. Batzel, 1995 Del. Ch. LEXIS 47 (Del. Ch. 1995). *See also* Bodell v. General Gas & Elec. Corp., 140 A. 264, 267 (Del. 1927); Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971).

38 A tender offer must remain open at least twenty days. Securities Exchange Act, Rule 14e-1, 17 C.F.R. § 240.14e-1 (2000).

the pro rata requirement;[39] the all holders' requirement;[40] the best price rule;[41] and withdrawal rights.[42]

For their part, the Gould forces resisting the Vanderbilt takeover attempt would have been likewise constrained by federal law. In this connection, more details on Gould's defensive issuance of stock and convertible bonds would be interesting. Had these stock issuances been public offerings, Gould and the Erie would have fallen under the Securities Act of 1933.

Suppose that they had been. What difference would this have made? Could Gould have avoided the delay and disclosure by coming within the "private placement" exemption by limiting the marketing to fewer than thirty-five sophisticated investors? The problem with such a strategy would be that the shares would have been restricted and, therefore, could not have been resold anonymously on the secondary market to Vanderbilt. Thus, the federal legislation would likely have precluded the grossest aspect of Gould's defensive tactics, namely, the secret issuance of convertible bonds to favored purchasers who immediately resold the shares to Vanderbilt.

But much of this is somewhat beside the point. From a contemporary perspective, one is most struck by the *crudeness* of Gould's tactics. We have come very far in the development of much cheaper, much more effective tactics to defend against unwelcome attempts to gain control. The modern-day Gould would have a poison pill in place and, even if he did not, would be able to adopt one in less than an afternoon. Because the flip in and flip over provisions of the plain vanilla poison pill drastically dilute the interest of the acquiring person, no one — not even Commodore Vanderbilt himself — would become an acquiring person unless the poison pill were to be first removed either by board action or judicial injunction.

As a defensive device, the poison pill trumps Gould's strategic issuance of convertible bonds. It is both far more effective and far cheaper. While Gould apparently did not much care that the issuance of the convertible

39 If the offer is oversubscribed, shares must be accepted pro rata from all tendering shareholders. Securities Exchange Act, § 14(d)(6), 15 U.S.C. § 78n(d)(6) (1994).

40 Tender offer must be open to all security holders. Securities Exchange Act, Rule 14d-10(a)(1), 17 C.F.R. § 240.14d-10(a)(1) (2000).

41 The bidder must pay each tendering security holder the highest price paid to any other security holder during the tender offer. Securities Exchange Act, § 14(d)(7), 15 U.S.C. § 78n(d)(7) (1994); Securities Exchange Act, Rule 14d-10(a)(2), 17 C.F.R. § 240.14d-10(a)(2).

42 Tendering security holders are free to withdraw their shares until the tender offer closes. Securities Exchange Act, Rule 14d-7, 17 C.F.R. § 240.14d-7 (2000).

bonds diluted the existing shareholders' interests, he presumably would have preferred not to do so had he had a more effective, less dilutive alternative.

Moreover, the poison pill is every bit as audacious a legal innovation as anything Gould attempted. A poison pill works as follows. Using an authorized but unissued series of preferred stock, the firm issues "rights" to purchase those shares or a fraction of them. In addition, the rights have additional entitlements. In the typical poison pill, if someone (the "acquiring person") acquires 15% or more of the voting power of the company then outstanding without the advance permission of the board of directors, all the other shareholders become entitled to buy, say, $200 worth of additional shares for $100 for every share that they own (the "flip in" provision). Likewise, the typical poison pill also provides that if, somehow, an acquiring person, despite this flip in provision, merges with the company, then each shareholder, except for the acquiring person, has a similar right to purchase, again, say, $200 worth of shares of the surviving company at half price for each share that the shareholder owns (the flip over provision). The rights can be redeemed at a token amount up until someone acquires 15% without board permission, at which point they cannot be redeemed at all.

When, in a hundred years, corporate law scholars look back on corporate law of the 1980s and 1990s, they may well be astonished by the Delaware Supreme Court's decision in *Moran v. Household International*.[43] In what was one of the more amazing decisions of the Delaware courts of the 1980s, the Court held that the poison pill rights plan is valid under certain circumstances. It turns out, of course, that those circumstances matter. Much of the subsequent tender offer jurisprudence from Delaware has involved a careful working out of when the board may use a poison pill to block a hostile acquisition and when not.

3. New York Stock Exchange Rules

Finally, because the Erie was listed on the New York Stock Exchange, shareholder approval would have been required for any issuance of shares in excess of 20%, whether or not there were sufficient authorized but unissued shares in the certificate of incorporation.[44]

Interestingly, during the various Erie battles, the Erie fought with the NYSE (then called the New York Stock and Exchange Board) and its competing exchange, the Open Board, over compliance with listing rules. During these battles, both exchanges sought to force the registration of

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43 500 A.2d 1346 (Del. 1985).

44 New York Stock Exchange Listed Company Manual ¶ 312.03 (2000).

securities to prevent overissuance. The exchanges wanted notice to the public before issuance of new stock. When the Erie Railroad did not comply, its stock was stricken from the trading list for a time. After the failure of a rival Erie Trading Board set up by Jim Fisk, the Erie Railroad succumbed to the requirements of the NYSE and was relisted.[45]

III. SOME IMPLICATIONS AND OBSERVATIONS

A. Protections against Non Pro Rata Distributions

From the safe distance of 130 years, one of the most amusing aspects of the Erie affair was the outrageous enthusiasm with which insiders lined their own pockets, typically (but not always) at the expense of outside shareholders. Thus, we see Daniel Drew, the "Speculative Director," pioneering new modes of stock manipulation, running the share price up and down almost at will. One of the most entertaining of the manipulations occurred just after Vanderbilt's hollow victory in gaining control over the Erie in Round One, which ended with Drew reassuming his position as a director. Adams regales us with an emblematic incident from the brief truce that followed:

> A combination of capitalists ... took advantage of this to transfer as much as possible of the spare cash of the "outside public" from its pockets to their own. A "pool" was formed, in view of the depressed condition of Erie, and Drew was left to manipulate the market for the advantage of those whom it might concern. ... One contributor to the "pool," in this instance, was Mr. —, a friend of Vanderbilt. The ways of Mr. Drew were, as usual, past finding out; Mr. —, however, grew impatient of waiting for the anticipated rise in Erie, and it occurred to him that, besides participating in the profits of the "pool," he might as well turn an honest penny by collateral operations on his own account, looking to the expected rise. Before embarking on his independent venture, however, he consulted Mr. Drew, it is said, who entirely declined to express any judgment as to the enterprise, but at the same time agreed to loan Mr. — out of the "pool" any moneys he might require upon the security usual in such cases. Mr. — availed himself of the means thus put at his disposal, and laid in a private stock of Erie. Still, however, the expected rise did not take place. Again he

45 Werner & Smith, *supra* note 1, at 145, *citing* Birl E. Shultz, The Securities Market and How It Works 11 (1963).

> applied to Mr. Drew for information, but with no better success than before; and again, tempted by the cheapness of Erie, he borrowed further funds of the "pool," and made new purchases of stock. At last the long-continued depression of Erie aroused a dreadful suspicion in the bull operator, and inquiries were set on foot. He then discovered, to his astonishment and horror, that his stock had come to him through certain of the brokers of Mr. Drew. The members of the "pool" were at once called together, and Mr. Drew was appealed to on behalf of Mr. —. It was suggested to him that it would be well to run Erie up to aid a confederate. Thereupon, with all the coolness imaginable, Mr. Drew announced that the "pool" had no Erie and wanted no Erie; that it had sold out its Erie and had realized large profits, which he now proposed to divide. Thereafter who could pretend to understand Daniel Drew? Who could fail to appreciate the humors of Wall Street? The controller of the "pool" had actually lent the money of the "pool" to one of the members of the "pool," to enable him to buy up the stock of the "pool"; and having thus quietly saddled him with it, the controller proceeded to divide the profits, and calmly returned to the victim a portion of his own money as his share of the proceeds. Yet, strange to say, Mr. — wholly failed to see the humorous side of the transaction, and actually feigned great indignation.[46]

Indeed, stock manipulation was such common practice that it was reflected in the very definitions of basic terms. Today, a "bull" is one who *expects* prices to rise, while a "bear" is one who *expects* them to fall. In the 1860s, Charles Adams reported the following definition: "A bull, in the slang of the stock exchange, is one who *endeavors* to increase the market price of stocks, as a bear *endeavors* to depress it. The bull is supposed to toss the thing up with his horns, and the bear to drag it down with his claws."[47] The difference is between expectation and agency.

We see all the other variants of self-dealing as well. Gould's and Fisk's almost constant exploitation of the Erie for personal gain sometimes interfered with their ability to operate it well, sometimes not. Two anecdotes are representative. The United States Express Company had a contract with the Erie. When Gould, on behalf of the Erie, demanded a higher rent, the Express Company refused. Gould thereupon informed the latter that the Erie would organize a new express company. This drove the price of United States Express Stock from $60 to $16. Gould bought heavily at

46 Adams, *supra* note 2, at 15-16.

47 *Id.* at 7 n.*.

this lower price, then signed a new contract at a substantially higher rent. When the stock recovered, he sold, making a reported $3 million profit on the trading.[48] Would such trading be permissible today or would it violate 10b-5? Did the trading harm the Erie? Interestingly, whether or not one can use material non-public information (that the Erie was about to sign a new contract) to trade in the securities of a different corporation to whom one owes no fiduciary duties (United States Express Company) remains an open question.

The most common manipulation, however, revolved around trading in the shares of one's own firm. As we saw above, Daniel Drew, was a pioneer in stock manipulation, followed closely by Gould and Fisk. The incentive for this sort of speculation, which requires quick trading on movements in the share price (often known in advance by or caused by insiders), has been removed by section 16(b)'s rule requiring the disgorging of profits on short swing trading by insiders and large shareholders. A seemingly crude statute, this is, in fact, a subtle and remarkably well-crafted measure to redirect the Daniel Drews of the world from spending their days going into and out of their company's stock, to managing for the long term.[49] With a holding period of six months, many of Drew's manipulations lose their purpose.

When, in 1872, Gould was finally prevailed upon to leave the Erie, the McHenry group was convinced to pay the Gould board $300,000 to resign, subsequently reimbursed from the Erie treasury.[50] Were this a straight payment for corporate office, it would be illegal today.[51] Were it disguised more cleverly, it would be a closer question.

Casual empiricism and more systematic studies both suggest that the single most important feature of corporate law is its success in controlling self-dealing. An enforced prohibition on "non pro rata distributions" — of cash or property, tangible or otherwise — is what aligns the interests of controlling shareholders with those of non-controlling shareholders and

48 Grodinsky, *supra* note 2, at 82.

49 Merritt B. Fox, *Insider Trading Deterrence versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 Mich. L. Rev. 2088 (1994); Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 Hastings L.J. 391, 399 (1991) ("Section 16 does much more than regulate the use of corporate information; it discourages those who control publicly held corporations from manipulating corporate affairs to create opportunities to trade corporate stock profitably.").

50 Grodinsky, *supra* note 2, at 100.

51 *See, e.g.*, Essex Universal Corp. v. Yates, 305 F.2d 572 (2d Cir. 1962); Caplan v. Lionel Corp., 246 N.Y.S.2d 913 (App. Div.), *aff'd*, 14 N.Y.S.2d 877 (Ct. App. 1964).

renders the corporate form "incentive compatible." Judging from the ease with which Gould enriched himself through such actions, it seems clear that such protections were lacking in the 1860s. They are apparently also lacking in Russia of today. By contrast, shareholders seem to be reasonably well protected from such self-dealing in the modern U.S. What is doing the work? Why was investing in the Erie as an outsider a stupid move in 1869, but investing as an outsider in Microsoft during the 1980s and 1990s not?

For those who teach corporate law and spend the course poking holes in the web of legal regulation that constrains insiders and controlling shareholders, it is easy to think that the law is a weak constraint on managerial self-dealing. Impressed with this weakness, one might think that the constraints largely derive from self-help, private ordering, and institutional design.

But the effectiveness of the legal protections has recently been given support by some important empirical research by the economists Cliff Holderness and Dennis Sheehan.[52] In a study of U.S. corporations with single shareholders who own more than 50%, they arrive at some interesting conclusions. First, such firms survive and do not appear to trade at significant discounts to comparable firms with diffuse ownership.[53] While there is some evidence of discount, there is no evidence that block investors have a large negative effect. Thus, something must be constraining large shareholders other than "price protection."

Holderness & Sheehan ("H&S") next search for differences in organizational structure between firms with controlling shareholders and those without to see if parties adopt different institutional measures to protect minority shareholders from majority shareholders. They pair majority-controlled NYSE or Amex listed firms with diffusely-held firms with the same two-digit SIC industry code that is closest in total assets and is listed on the NYSE or Amex, in order to create a sample of 101 majority shareholder corporations. H&S find no evidence of increased use of outside directors in majority shareholder firms nor any evidence of audit committees being used to constrain majority shareholders. Other monitoring devices (such as auditors) likewise do not appear with greater frequency with majority shareholders. In summary, then, the standard organizational constraints thought to control abuse by majority shareholders are not more prevalent in majority-controlled firms.

It is worth noting the limitations of H&S' findings. They search for

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52 Clifford G. Holderness & Dennis P. Sheehan, *Constraints on Large-Block Shareholders, in* Concentrated Corporate Ownership 139 (Randall Morck ed., 2000).

53 *Id.*

differences between organizational structures in diffusely-owned versus majority-owned firms. Both types of firms face agency costs: in the first, from managers; in the second, from majority shareholders. The fact that no differences emerge is consistent with both types of firms adopting the standard set of institutional protections, but for different reasons. Indeed, nearly all firms have outside directors. If they make a difference, the biggest difference is likely to occur between 0 and 2 outside directors, and not between 2 and 3 or 4.

Finally, H&S find that minority shareholders in majority-controlled firms receive the same premia in reorganizations and buyouts as do shareholders in diffusely-owned firms. This is inconsistent with majority shareholders taking advantage of minority shareholders in freeze-outs.

H&S' empirical findings provide circumstantial evidence of the existence of legal protections of minority shareholders, both day-to-day and in an end game freeze-out. Elsewhere, Barclay and Holderness have provided additional empirical evidence.[54] One's casual impression from Gould's predations is that these protections were lacking in the 1860s. Likewise, more systematic evidence suggests that these protections are similarly lacking in many contemporary systems.[55] If this is correct, it represents a fundamental and fundamentally important transformation that makes possible flexibility across other dimensions.

Consider, for example, the history of vote buying. It went from accepted practice in the Railroad Age, to a flat prohibition, to the current case-by-case analysis under Delaware law. How one feels about vote buying depends largely on one's view of the efficacy of other pieces of the fabric, principally, the prohibitions on non pro rata distributions. On the one hand, it is not difficult to come up with situations in which permitting vote buying will benefit shareholders.[56] On the other hand, one worries about how the buyer of

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54 *See* Michael J. Barclay & Clifford G. Holderness, *Private Benefits from Control of Public Corporations*, 25 J. Fin. Econ. 371 (1989); Michael J. Barclay & Clifford G. Holderness, *Negotiated Block Trades and Corporate Control*, 46 J. Finance 861 (1992); Michael J. Barclay & Clifford G. Holderness, *The Law and Large-Block Trades*, 35 J.L. & Econ. 265-94 (1992).

55 Rafael La Porta et al., *Legal Determinants of External Financing*, 52 J. Finance 1131-50 (1997).

56 *See, e.g.*, Schreiber v. Carney, 447 A.2d 17 (Del. Ch. 1982). *More generally, see* Andre, *supra* note 27; Henry Manne, *Some Theoretical Aspects of Share Voting: An Essay in Honor of Aldolf A. Berle*, 64 Colum. L. Rev. 1427, 1436 (1964); Robert Clark, *Vote Buying and Corporate Law*, 29 Case W. Res. L. Rev. 776 (1979). *But see* Frank Easterbrook & Daniel Fischel, The Economic Structure of Corporate Law 74-76 (1991).

votes will make a profit and suspects that it will be through some sort of non pro rata distribution.

Given this tradeoff, where the balance is struck will depend on the extent to which one thinks that the vote buyer's inclination to engage in self-dealing will be constrained by other features of the law. If the protections are robust, one can adopt a flexible rule in an effort to permit beneficial vote buying. If the protections are weak, then prohibiting it outright may be the only way to prevent the Goulds or Vanderbilts from using it to line their own pockets.

B. The Mutability of Law and the Role of Federalism

Economists take law as a given, as a boundary condition within which a rational actor maximizes. Lawyers realize that law is mutable. The importance of this is highlighted by the battle for the Erie. The law was changed over several dimensions. First, the competing injunctions from different New York judges repeatedly changed the ground rules. This arose, as mentioned above, from the peculiar New York judicial structure that allowed different local trial court judges to issue conflicting statewide injunctions in the same case.

Second, after Gould and confederates fled to Jersey City, the battle shifted in two ways. Initially, New Jersey granted the Erie a charter, allowing it to continue operating. Then, because the principal arena remained New York (because the shares issued to defeat Vanderbilt's takeover bid had been issued under New York law), the battle shifted to New York's capital, Albany. There, Gould, against Vanderbilt opposition, fought to change the law to legalize, *ex post*, the (illegal) issuance of stock. Recall that Gould succeeded in convincing the Legislature and Governor by means of a liberal distribution of cash.

Third, once Gould had defeated Vanderbilt, he solidified his hold over the Erie by means of the legislative classification of the Erie Board into five classes, achieved with the essential assistance of his Tammany Hall allies.

Finally, Gould's efforts to expand the Erie westward, in competition with Vanderbilt and the Pennsylvania, failed, in part, because of the Pennsylvania Railroad's control over the Pennsylvania Legislature and the influence wielded by the Pennsylvania's Ohio allies in the Ohio Legislature.

The obvious lesson from these battles is that corruption undermines the rule of law, thereby interfering with the evolution of useful capital markets.

But there is also a much more interesting, although perhaps more speculative, aspect. The battle for the Erie was fought out in an environment in which there were competing and overlapping corrupt sovereignties. This meant that victories could be bought, but all that could be sold was a temporary advantage. The losers in one skirmish could endeavor to shift the battle to a more friendly forum. The victors in one forum could find themselves at a disadvantage when the arena shifted: Gould's purchased influence in Albany (New York) was useless against the Pennsylvania's purchased dominance in Harrisburg (Pennsylvania).

Here we see an illustration of the liberty-enhancing benefits of decentralized power.[57] As corrupt as the various judges and legislatures were, no corrupt outcome was stable. In the instability lay a fundamental limitation on the power of any given state to dictate outcomes or to limit competition or other forms of rivalry.

This is a theme that has resonated in corporate law through the decades. During the takeover battles of the 1980s, management, often with the assistance of organized labor, turned to state legislatures for protection against hostile tender offers. This was both general and in response to particular bids. State legislatures were often receptive to demands from these important and focused in-state interests, especially when contesting with the largely out-of state bidders. The federal courts tended to avoid entanglement, at least once the antitakeover forces had learned from the *CTS* case that one could protect incumbent management through tinkering with the state law definition of shareholders' interests.[58] Despite management's state legislative victories, merger and acquisition activities reached all time peaks during the 1990s.

There are, it seems to me, two principal explanations for this outcome, both of which can be observed in the Erie wars. First, as the Railroad Age demonstrated, when there are gains to trade, there is always what one might call a "Coasean solution" to impediments: bribery, direct and indirect. The legislative victories simply mean that a bidder has to convince incumbent management to acquiesce in a bid, thereby transforming it from being "hostile" to "friendly." Incumbent management's acquiescence can be purchased in either of two ways, *ex ante* and *ex post*. The widespread adoption of heavily incentivized compensation, combined with the acceleration of vesting of those options upon a change of control, means that a takeover at a normal premium can make incumbent management seriously rich. When this is not a sufficient inducement, there are numerous ways in which incumbent management can be encouraged, including

57 The seminal articulations of this thesis are Karl Wittfogel, Oriental Despotism: A Comparative Study of Total Power (1957), and Barrington Moore, Social Origins of Dictatorship and Democracy (1966).

58 CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987).

consulting agreements, "stay bonuses," and equity ownership. No matter how rich incumbent managers become from these payments, the amounts are almost never material given the overall size of the deal.

But there is a second, critical element. As in the Railroad Age, a federal system, combined with regional or national markets, limits the protection that states can provide their favored in-state corporations. The existence of competing states meant that in the 1990s, corporations in protective states saw their stock prices drop.[59] Large institutional investors responded by putting pressure on recalcitrant managers, using various internal levers (see, e.g., the "just vote no" campaigns). Convincing one state legislature was not enough; and given the distribution of firms and shareholders, convincing all of them was not possible. As others have noted, it is not coincidental that Delaware, with its more even mix of bidders and targets, has the most even-handed set of takeover rules (judge-made and legislative).[60]

C. Antitrust and Stock Speculation

A final theme emerges from the battle for the Erie. Why was it so easy to speculate in Erie stock? Why was the stock itself so volatile? More generally, why were railroads a prime arena for stock and rate pools?

Here one finds an interesting and tight connection between antitrust and corporate law. Railroads are characterized by extraordinarily high fixed costs (primarily the building of the roads themselves) and extraordinarily low marginal costs. In some countries, these properties meant that railroads were built and operated by the government or regulated as public utilities under government-granted monopolies. In the U.S., the railroads emerged through the private sector, with some minor government involvement, largely through subsidies, but without any sort of comprehensive regulation. At the same time, there were only the weakest legal constraints on agreements to eliminate competition.

The laissez-faire development of railroads led to a crazy quilt of lines crisscrossing the United States.[61] Competing lines were sometimes built

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59 Samuel Szewczyk & George Tsetsekos, *State Intervention in the Market for Corporate Control: The Case of Pennsylvania Senate Bill 1310*, 31 J. Fin. Econ. 3 (1992). For a discussion of the wealth effects of state antitakeover statutes, including Pennsylvania's, and the power of large shareholders to defuse it, see Ronald Gilson & Bernard Black, The Law and Finance of Corporate Acquisitions 1395-99 (2d ed. 1995).

60 Roberta Romano, The Genius of American Corporate Law 59-60 (1993).

61 Grodinsky, *supra* note 2, at 68 fig. 1 (map of the Erie's service area).

purely in order to be bought out by the incumbent, dominant line. Railroads could go from profit to loss overnight. These peculiar economics are what Charles Adams and the early "prophets of regulation" relied upon to argue successfully for the public regulation of railroads. Railroads, therefore, were not only America's first publicly-held corporations, but also its first experience with public regulation.

The same laissez-faire legal environment that led to intense competition in the building of railroads also led competing railroads to form pools to eliminate competition *inter se* or, when pools were ineffective, to try to merge. When pools were effective, rates rose, as did railroad profits and stock price. When pools fell apart, price wars broke out, profits dropped, and, with them, stock prices. As long as one knew in advance that a pool was forming or dissolving, one could make money on the shares of the participant railroads, and insiders did precisely that.

Here we see a striking connection. Cartels or pools — in any industry — are the single most effective way of raising profits in the short run. And nothing moves the stock price like fluctuations in earnings. The legality of pools multiplied the opportunities for stock trading profits immeasurably, providing a ready source of highly material non-public information and providing a ready means for moving the price of shares up or down, at will. Put differently, the Sherman Act, by prohibiting cartels, eliminated many of the most promising opportunities for stock manipulation and insider trading. Oddly, then, it may be that the emergence of regulation in the rail industry, first by state railroad commissions and subsequently by the Interstate Commerce Commission, was one of the developments that tamed the capital market, not by constraining the speculators but by reducing their opportunities for speculation.

EPILOGUE

In 1960, the Erie merged with its long time rival, the Delaware, Lackawanna and Western Railroad to become the Erie Lackawanna Railroad. In 1968, the Pennsylvania entered into a disastrous merger with the New York Central to form the Penn Central. By 1970, the Penn Central had filed for bankruptcy. Then, in 1976, out of the ruins of the Northeast railroad business, Conrail was formed, acquiring the rail assets of the old Pennsylvania, New York Central, and Erie. In 1997, Norfolk Southern and CSX (the successor to, among others, the old Baltimore & Ohio and Chesapeake & Ohio Railways) jointly acquired Conrail, dividing the rail lines between them.