
Principal Costs:

**A New Theory for Corporate Law and
Governance**

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Table of Contents

I. INTRODUCTION	3
II. THE LIMITS OF AGENCY-COST THEORY.....	9
A. THE JENSEN–MECKLING MODEL AND ITS EXTENSIONS.....	10
B. THE SHORTCOMINGS OF AGENCY-COST THEORY	13
III. THE THEORY OF PRINCIPAL COSTS.....	17
A. COMPETENCE COSTS	20
B. THE BYPRODUCT OF COMPETENCE-RAISING DELEGATION: CONFLICT COSTS.....	25
C. SYNTHESIS: THE CONTROL-COST MATRIX.	32
D. THE TRADEOFF BETWEEN PRINCIPAL COSTS AND AGENT COSTS	33
E. THE MECHANICS OF DELEGATION	36
F. UNDERSTANDING THE GOVERNANCE SPECTRUM: DELEGATION AND ACCOUNTABILITY	40
G. STRUCTURES ALONG THE SPECTRUM	45
IV. PRINCIPAL-COST THEORY VERSUS AGENCY-COST THEORY: IMPLICATIONS	50
A. EMPIRICAL PREDICTIONS	50
B. IMPLICATIONS FOR LAWMAKERS.	65
V. CONCLUSION	70

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The dominant paradigm in corporate law is agency-cost theory, which asserts that the law's proper role is to reduce managerial agency costs by forcing firms to allocate more control to shareholders. That theory cannot explain why shareholders voluntarily invest in firms that circumscribe their powers to hold managers accountable. This Article introduces principal-cost theory, which states that each firm's optimal governance structure minimizes the sum of principal costs, produced when investors exercise control, and agent costs, produced when managers exercise control. Because the optimal division of control is firm-specific, firms rationally select from a range of governance structures that empower shareholders to varying degrees. Principal-cost theory generates more accurate empirical predictions than agency-cost theory. It also suggests different policy prescriptions: rather than banning some governance features and mandating others, lawmakers should permit each firm to tailor its structure based on its firm-specific substitution rate between principal costs and agent costs.

I. Introduction

For the last forty years, agency-cost theory has dominated the study of corporate law and governance.¹ The theory holds that the most important problem in corporate governance is the conflict of interests between managers (the agents) and shareholders (the principals). That conflict arises from the separation of ownership and control, under which managers run the firm but share its profits with the shareholders. Managers thus face incentives to

¹ For the seminal work, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (developing a formal analysis of agency costs).

expend less effort, and consume more perquisites, than they would if they owned the firm entirely themselves. By shirking and diverting in such ways, managers generate agency costs, which reduce a firm's value. To reduce agency costs, theorists would mandate corporate governance arrangements such as proxy access, which empower shareholders to hold managers accountable,² they also would ban arrangements such as staggered boards³ and dual-class shares,⁴ which disempower shareholders. To agency-cost theorists, the reduction of agency costs is an unalloyed good, toward which all aspects of corporate law and governance should be directed.⁵

There can be no doubt that the theory of agency costs has deepened our understanding of business firms. As, however, it is applied to current debates in corporate law, agency-cost theory has a narrowness of focus that leaves it unable to explain basic features of business firms. Drawing upon a seminal paper by Michael Jensen and William Meckling,⁶ agency-cost theorists assume that firms delegate control to managers, thereby separating control from ownership, solely to facilitate the aggregation of capital from multiple investors and thus to achieve economies of scale.⁷ Yet many wholly-owned firms also delegate control to managers, thereby incurring agency costs which, under agency-cost theory, serve no function. Agency-cost theorists also cannot explain why

² See, e.g., Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329 (2010).

³ See, e.g., Lucian A. Bebchuk, John C. Coates & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) (criticizing staggered boards for generating agency costs).

⁴ See, e.g., Lucian A. Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP (Randall K. Morck, ed., 2000), available at <http://www.nber.org/chapters/c9013.pdf>.

⁵ See, e.g., Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) [hereinafter Bebchuk, *The Case*].

⁶ Jensen & Meckling, *supra* note 1.

⁷ Economies of scale are cost advantages obtained by organizations due to their size, output, or scale of operation. See generally *Economies of Scale*, Investopedia, <http://www.investopedia.com/terms/e/economiesofscale.asp> (last visited Apr. 8, 2016).

investors often place their capital with public corporations with staggered boards, which allow shareholders to replace their agents only at specified intervals,⁸ or in dual-class firms, which deny outside shareholders the right to replace agents at all.⁹ If economies of scale were the sole benefit of delegating control to managers, investors would have no reason to tie their hands in such ways. Clearly, investors can also generate costs when they exercise control, and firms must weigh those costs against agency costs when selecting a governance structure. By ignoring that tradeoff, agency-cost theory produces inaccurate empirical predictions and unwise policy prescriptions.

To correct these shortcomings, this Article introduces a new theory of the proper role of law in corporate governance. The theory states that each firm's optimal governance structure minimizes total *control costs*, which are the sum of *agent costs* and *principal costs*. Agent costs occur when managers exercise control, and principal costs occur when investors exercise control. Because of the separation of ownership and control, agents can act in self-seeking ways, generating agent *conflict* costs. But they also can make honest mistakes due to a lack of ability, expertise, or information, generating agent *competence* costs. Similarly, when investors exercise control, they can do so in self-seeking ways, generating principal conflict costs, and they can make honest mistakes, generating principal competence costs. Agent costs and principal costs are substitutes for each other: any reallocation of control rights among investors and managers decreases one type of cost but increases the other. The rate of substitution is firm-specific, driven by factors such as business strategy, industry, and the personal characteristics of the key parties. Therefore, each firm has a distinct division of control rights that minimizes total control costs. Because the cost-minimizing division varies by firm, the optimal governance structure does as well. The implication is that

⁸ State law enables firms to adopt governance arrangements that give shareholders the ability to replace corporate directors at any time. *See, e.g.*, Del. Code Ann. tit. 8, § 141(a), (d) (allowing certificate of incorporation to provide for alternative governance structures).

⁹ *See* Zohar Goshen & Assaf Hamdani, *Idiosyncratic Vision and Corporate Control*, 125 YALE L.J. 560, 588–91 (2016) (explaining that the dual-class share structure precludes the replacement of managers by investors).

law's proper role is to allow firms to select from a wide range of governance structures, rather than mandating some structures and banning others.

Agency-cost theory focuses almost entirely on only one of the four categories of control cost we have identified: agent conflict costs.¹⁰ It downplays agent competence costs, and more importantly, it essentially disregards both types of principal cost. Yet principal costs are just as important as agent costs, as they are the factor against which firms must weigh agent costs when deciding how much control to allocate to investors and how much to allocate to managers. When a firm has multiple investors, principal costs can have many causes, including conflicts of interest among investors and group decision-making problems.¹¹ But even if a firm has just one investor, principal costs—in particular, principal competence costs—will arise whenever the investor makes honest mistakes due to a lack of ability, information, or expertise. Indeed, the goal of reducing principal competence costs explains why even wholly-owned firms are often run by managers rather than investors.

The firm-specific nature of the tradeoff between principal costs and agent costs explains why firms adopt a wide variety of governance structures, each of which offers a different division of control between investors and managers. At one end of the spectrum is the dual-class share structure, which gives controlling owner-managers complete and incontestable control. Firms which adopt that structure minimize potential principal costs but run the risk of high agent costs. At the opposite extreme—rarely seen except in sole proprietorships and small partnerships—are firms in which the equity investors retain full control over the selection and development of the firm's business strategy. Such firms minimize potential agent costs but run the risk of high principal costs. Toward the middle of the spectrum is the most common

¹⁰ See, e.g., John Armour et al., *What is Corporate Law*, in *THE ANATOMY OF CORPORATE LAW* 1, 2 (Reinier Kraakman et al., eds., 2d ed. 2009) (“[M]uch of corporate law can usefully be understood as responding to three principal sources of opportunism: conflicts between managers and shareholders, conflicts among shareholders, and conflicts between shareholders and the corporation's other constituencies. . .”).

¹¹ See Henry Hansmann, *Ownership of the Firm*, 4 *J.L. ECON. & ORG.* 267 (1988) (analyzing shareholders' decision-making problems).

governance structure in American public corporations: dispersed share ownership.¹² Managers of firms with that structure exercise a large degree of control, which can generate significant agent costs. But the managers' control can be contested through a hostile tender offer or shareholder activism, the prospect of which keeps agent costs in check. But because hostile raiders and activist hedge funds sometimes mistakenly target firms whose managers are in fact effective,¹³ this ownership structure can also generate significant principal costs.

This Article is not the first to observe that shareholders (as opposed to managers) generate costs when exercising control. Previous scholarship had identified particular sources of what we call principal costs,¹⁴ such as short-termism, shareholder conflicts of interests, and collective-action problems.¹⁵ This Article is,

¹² Concentrated ownership is usually contrasted with the dispersed ownership structure, the most prevalent structure in the United States and the United Kingdom, in which most of the firm's shares are widely held. See generally Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. FIN. 1301, 1301 (2003) (stating that roughly 30% of S&P 500 companies have families as controlling shareholders); Marco Becht & J. Bradford DeLong, *Why Has There Been So Little Block Holding in America?*, in HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS 613 (Randall K. Morck ed., 2005). But see Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377 (2009) (presenting evidence that raises doubts as to whether the ownership of U.S. public firms is actually dispersed).

¹³ See *infra* note 143 and accompanying text.

¹⁴ The authors thank Anna Shifflet, their research assistant, for suggesting the term.

¹⁵ See, e.g., Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347 (1991) (identifying voting pathologies in shareholder business proposals); Bernard Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1991-1992) (discussing the conflicts of institutional investors); Edward Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987 (1994) (same); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 Colum. L. Rev. 795 (1993) (discussing the conflicts of public pension funds); Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. Corp. L. 265, 269 (2011) (analyzing the short-termism problem); see also *infra* sections

however, the first to describe the complete set of control costs (including both conflict and competence costs), to recognize that principal costs constitute a general category on par with agent costs, and to show that the unavoidable tradeoff between principal costs and agent costs determines each firm's optimal governance structure. These contributions make salient two aspects of the corporate-governance problem that agency-cost theorists neglect. First, a firm will suffer control costs regardless of who exercises control—investors or managers. Second, because the impact of a given governance structure on control costs is firm-specific, there is no particular governance structure that can be described as intrinsically good, bad, welfare-enhancing, or inefficient.

One test of a theory is the accuracy of its predictions. The theory we introduce here—which we term principal-cost theory—makes different predictions than agency-cost theory about the relationship between firm value and particular governance structures. Agency-cost theory suggests that firms which adopt shareholder-disempowering governance features, such as staggered boards and dual-class shares, will consistently underperform those that do not. Principal-cost theory, by contrast, suggests that shareholder-disempowering governance features will be efficient for some firms but not others, based on firm-specific characteristics. Therefore, an empirical study that properly controls for such characteristics will find no correlation between the structural feature and firm value. As we show in this Article, principal-cost theory does in fact predict the results of most empirical studies better than agency-cost theory does.¹⁶

A second test of a theory is the wisdom of its policy prescriptions. The current legal debate over corporate governance focuses almost exclusively on agency costs. The debate pits the shareholder-supremacy school,¹⁷ which thinks agency costs are a big problem, against the director-supremacy school,¹⁸ which thinks they are a small problem. The first school wants lawmakers to shift

II.A.1, II.B.1 (comparing previous scholarship with principal-cost theory).

¹⁶ See *infra* section IV.A.

¹⁷ See, e.g., Bebchuk, *The Case*, *supra* note 5.

¹⁸ See, e.g., Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006).

more control to shareholders in all firms,¹⁹ while the second wants them to insulate corporate managers from control contests.²⁰ Principal-cost theory suggests that both policy prescriptions are unwise, as both would treat all firms the same.²¹ Because the governance structure that minimizes control costs varies by firm, lawmakers—including courts, regulators, and legislators—should avoid one-size-fits-all solutions. Rather, in the absence of clear market failures, they should presume the efficiency of each firm’s chosen governance structure. And they should seek to grow, rather than shrink, the menu of governance-structure options.

The plan of the Article from here: Part II describes the prevailing paradigm in corporate law, agency-cost theory, and identifies its shortcomings, especially its inability to explain common structural features of business firms. Part III introduces principal-cost theory and shows why it can explain what agency-cost theory cannot. It also describes how the governance structures selected by firms can be placed along a spectrum, each of which strikes a different tradeoff between principal costs and agent costs. Part IV describes how principal-cost theory generates better empirical predictions and policy prescriptions, and Part V is the conclusion.

II. The Limits of Agency-Cost Theory

The subject of most corporate-law scholarship is the conflict of interests between managers (broadly defined to include directors) and shareholders. Scholars almost invariably conceptualize this conflict in terms of agency costs: the economic losses that occur due to managers’ incentive to engage in self-seeking conduct that puts their personal interests ahead of the goal of maximizing their firm’s value.²² Scholars who believe that agency costs are a large problem—we refer to them as “agency-cost theorists”—consistently evaluate policy recommendations in terms of their capacity to decrease agency costs, and they condemn governance

¹⁹ See, e.g., Bebchuk, *The Case*, *supra* note 5.

²⁰ See, e.g., Bainbridge, *supra* note 18; Martin Lipton & Steven A. Rosenblum, *A New System of Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 205–13 (1991).

²¹ See *infra* section IV.B.

²² See articles cited *infra* notes 86-92, and accompanying text.

arrangements, such as concentrated ownership and dual-class shares, that fetter shareholders' ability to hold managers accountable.²³ Because, however, investors also generate costs when they exercise control or hold managers accountable, agency-cost theory cannot explain common features of the governance structures that most firms adopt.

A. The Jensen–Meckling Model and Its Extensions

Although keen observers have been commenting on the problem of agency costs since antiquity,²⁴ the most influential modern analysis of agency costs in business firms is a 1976 article by Michael Jensen and William Meckling.²⁵ The article employs a simple model of a firm owned jointly by an investor and a manager. The manager runs the firm, while the investor provides capital that, in combination with capital provided by the manager, enables the firm to achieve economies of scale.²⁶ But the use of the investor's capital has a downside. In exchange for it, the manager must give the investor a cut of the cash flows that the firm generates, introducing a separation between ownership (the right to cash flows) and control (the right to run the firm). This separation creates incentives for the manager to engage in self-seeking behavior that reduces the firm's value. He no longer has incentive to work as hard, because the sharing of cash flows with the investor reduces his marginal returns from working relative to his marginal returns from leisure. And the sharing of cash flows also increases the manager's incentive to divert the firm's resources to himself in the form of prerequisites,²⁷ because he only bears part of the cost of doing so. The investor cannot costlessly deter such self-

²³ See, e.g., Bebchuk, Kraakman & Triantis, *supra* note 4.

²⁴ See, e.g., John 10:12-13 (“The hired hand is not the shepherd and does not own the sheep. So when he sees the wolf coming, he abandons the sheep and runs away. Then the wolf attacks the flock and scatters it. The man runs away because he is a hired hand and cares nothing for the sheep.”). New International Version, 1978.

²⁵ Jensen & Meckling, *supra* note 1.

²⁶ See *id.* at 312.

²⁷ See *id.* at 312. For example, the manager is more likely to move his modest office to a nicer building, to hire more underlings so that he can work shorter hours and enjoy being the boss, and to invest the firm's resources in projects in which he has a personal interest.

seeking conduct by the manager, and thus the conduct is likely to occur. The direct costs of such shirking and diverting by the manager, plus the costs that the parties incur to prevent them, are what Jensen and Meckling called *agency costs*.

The essential problem that Jensen and Meckling used this simple firm to illustrate is the unavoidable tradeoff between economies of scale and agency costs. Both rise as the firm's manager sells more of its cash flows to the investor in exchange for more capital. The optimal division of cash flows between investor and manager is the one that maximizes economies of scale net of agency costs. In this way, the Jensen-Meckling model shows how the tradeoff between economies of scale and agency costs determines the size of a business firm.

A second important contribution of the Jensen-Meckling paper is its description of the composition of agency costs. Importantly, agency costs do not just include the direct costs of managerial self-seeking behavior. Just as money spent on guard dogs and floor safes is part of the cost of burglary, efforts by investors to *monitor* managers are part of the cost of managerial misconduct. Jensen and Meckling further noted that efforts by managers to reassure investors that they will work diligently and scrupulously—which the authors called *bonding costs*—should also be considered agency costs.²⁸ Managers rationally incur bonding costs because investors who feel safe will charge less for the use of their capital. Thus, the full set of agency costs—the costs linked to actual or potential managerial misconduct—includes bonding costs, monitoring costs, and the direct costs of agent misconduct that bonding and monitoring do not prevent.²⁹

The Jensen-Meckling model has been extraordinarily influential.³⁰ Delaware courts have used it to frame their analyses.³¹ Among scholars of corporate law, the model inspired

²⁸ *See id.*

²⁹ *See id.* at 326. Jensen and Meckling called these direct costs “residual loss.” An example would be the loss of firm value caused by undeterred managerial shirking, net of the private benefit to the manager of that shirking.

³⁰ A Westlaw search of the term “agency cost” yields 15,141 results. WESTLAW, <https://1.next.westlaw.com/> (search “agency cost”) (last visited Aug. 26, 2016).

³¹ *See, e.g.,* Bird v. Lida, Inc., 681 A.2d 399, 402–03 (Del. Ch. Ct. 1996)

agency-cost theory, which has been used to frame debates over controversial topics such as executive compensation,³² hostile takeovers,³³ class actions and derivative suits,³⁴ director self-dealing,³⁵ the role of institutional investors,³⁶ the role of activist investors,³⁷ and shareholder rights to amend corporate bylaws and

(Allen, C.) (citing Jensen and Meckling for the proposition that “imperfect alignment of incentives will inevitably lead to excess costs associated with centralized management”).

³² See, e.g., Lucian Ayre Bebchuk & Jesse Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71 (2003); Robert J. Jackson, Jr., *Private Equity and Executive Compensation*, 60 UCLA L. REV. 638 (2013).

³³ See, e.g., Frank Easterbrook & Daniel Fischel, *The Proper Role of Target’s Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (emphasizing role of hostile takeovers “in monitoring the performance of corporate managers” and citing Jensen and Meckling); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 836–45 (1981) (arguing that defensive tactics are inappropriate because of the importance of a “market for corporate control” as a means of reducing agency costs).

³⁴ See, e.g., John C. Coffee, Jr., *Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 680 & n.30 (1986) (noting the “high ‘agency costs’ associated with class and derivative actions” and citing Jensen and Meckling); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs’ Attorney’s Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 12–25 (1991) (applying Jensen and Meckling’s theory to class and derivative actions); Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053 (1995) (analyzing securities class actions).

³⁵ See, e.g., Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 867 & n.11 (1991) (citing Jensen and Meckling).

³⁶ See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1283–84 (1991).

³⁷ See, e.g., Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Reevaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1085 (2007); Mark J. Roe, *Corporate*

charters.³⁸ The prevailing view among agency-cost theorists is that corporate law should be reformed to give more power for shareholders. For example, the theorists condemn corporate governance structures that insulate incumbent managers against hostile takeovers and activist hedge funds.³⁹ And they have applied similar reasoning to the conflict between controlling shareholders and minority shareholders, focusing on potential majority oppression of the minority.⁴⁰

B. The Shortcomings of Agency-Cost Theory

By necessity, models make simplifying assumptions that limit their explanatory reach. The Jensen-Meckling model is no exception. In, however, deriving policy prescriptions from the model, agency-cost theorists often ignore these limitations. As a result, they effectively assume that, at any given level of production, the only relevant governance goal is the minimization of agency costs—or, using our terminology, agent conflict costs. While this is true in the Jensen-Meckling model, it is not true in real business firms.

One such simplifying assumption in the Jensen-Meckling model is that the manager possesses all *discretionary control rights*—by which we mean the rights to select and implement the firm’s business strategy. Not only does the investor lack formal power to select the firm’s strategy, he also cannot try to influence it, such as by replacing the manager if he disagrees with the manager’s strategic plan.⁴¹ The only control rights possessed by

Short-Termism—In the Boardroom and in the Courtroom, 68 BUS. LAW. 977, 1005 (2013).

³⁸ See, e.g., Bebchuk, *The Case*, *supra* note 5.

³⁹ See, e.g., Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1165 (2013) [hereinafter Bebchuk, *The Myth*]; Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1136 n.99 (2015) [hereinafter Bebchuk, *Long Term*]; Easterbrook & Fischel, *supra* note 33; Gilson, *supra* note 33.

⁴⁰ For example, a recent paper addresses the risk of self-dealing by controllers by calling for “enhanced-independence directors” who are accountable to minority shareholders. See Lucian A. Bebchuk & Assaf Hamdani, *Making Independent Directors Work*, 116 U. PA. L. REV. (forthcoming 2016).

⁴¹ See Jensen & Meckling, *supra* note 1, at 313 (assuming that investors

the investor in the model are *duty-enforcement rights*—by which we mean rights to enforce contractual obligations, and perhaps judge-made fiduciary duties, designed to deter self-seeking conduct by the manager. It is the exercise of these rights that generate what Jensen and Meckling called monitoring costs.⁴² By disabling their investor from participating in discretionary control, Jensen and Meckling created a firm that can change along only one dimension: the amount of outside capital.

A second limiting assumption of the Jensen-Meckling model is that no one makes mistakes. While the manager does not always advance the interests of the investor, he serves his own interests flawlessly. He selects the most profitable business strategy available, and he executes it without error. Similarly, the investor always exercises his duty-enforcement rights in a way that minimizes agency costs. In other words, he only engages in *efficient* monitoring: he would never spend \$100 on monitoring that prevents only \$50 worth of managerial misdeeds. The model thus ignores competence costs. Therefore, the only costs that matter, at any given scale of production, are conflict costs, resulting from the separation of ownership and control. And these arise only because of actual and potential self-seeking by the manager. In practice, managers generate costs not just by deliberately shirking and diverting, but by making unwise decisions attributable to a lack of expertise, information, or natural ability. And investors make such mistakes as well, including by hiring the wrong manager. But mistakes are not part of the Jensen-Meckling model.

In combination, these two limiting assumptions exclude principal costs from consideration. The fault is not with Jensen and Meckling, who aimed, quite successfully, to show how agent conflict costs limit a firm's scale of production. But, while Jensen and Meckling were careful to acknowledge the limitation of their model,⁴³ agency-cost theorists have, in essence, applied the model

lack voting rights).

⁴² *See id.*

⁴³ *See id.* at 64 (“In particular, we have assumed that all outside equity is nonvoting A complete analysis of this issue will require a careful specification of the contractual rights involved on both sides, the role of the board of directors, and the coordination (agency) costs borne by the

to a different problem, namely the optimal division of control between investors and managers at any given level of production. And they have concluded, in effect, that the minimization of agent conflict costs is the only relevant factor in determining that division. Put another way, their theory is that the governance structure which minimizes agent conflict costs also maximizes the firm's value. It is for this reason that they consistently advocate governance structures that would increase the power of shareholders to hold managers accountable.⁴⁴

By excluding principal costs from their analysis, agency-cost theorists cannot explain why, even in a firm whose capital is provided by a single-wealthy investor, that investor often hires the manager to run the firm for her. Since the investor provides all funding, the explanation for use of a manager is not economies of scale, which is the only reason for the separation of ownership and control in the Jensen-Meckling model. Recognizing this blind spot, some theorists have motivated their models with a story along the lines that “the entrepreneur has the idea, and the investor has the money.”⁴⁵ But that story is inadequate, as the investor could, in theory, simply buy the idea from the entrepreneur. (In many firms, of course, that's exactly what happens, but in many others it does not.) Only a model that includes principal costs—starting with principal competence costs—can explain the use of managers in such firms.

A theory of business firms that excludes principal costs also cannot explain why investors often agree to tie their own hands,

stockholders in implementing policy changes Further analysis of these issues is left to the future.”); *id.* at 70 (“While we believe the structure outlined in the preceding pages is applicable to a wide range of corporations, it is still in an incomplete state. One of the most serious limitations of the analysis is that, as it stands, we have not worked out in this paper its application to the very large modern corporation whose managers own little or no equity. We believe our approach can be applied to this case, but space limitations preclude discussion of these issues here. They remain to be worked out in detail and will be included in a future paper.”).

⁴⁴ See, e.g., Bebchuk, *The Case*, *supra* note 5.

⁴⁵ See, e.g., Oliver Hart, *Financial Contracting*, 39 J. ECON. LIT. 1079, 1079 (2001); Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 475 (1992).

consenting to limitations on their power to hold managers accountable. The most important such power is the right to replace the manager at will. Agency-cost theory suggests that an investor's power to replace a manager is an extremely valuable deterrent of self-seeking managerial conduct.⁴⁶ Yet many large business firms adopt structures that place strict limitations on shareholders' power to remove and replace senior managers. For example, the standard American corporate form, which most public firms adopt, generally allows shareholders to replace corporate directors only once per year, at the annual shareholders meeting.⁴⁷ Other firms adopt staggered boards, each of whose members can only be replaced every third year, except for cause.⁴⁸ Private-equity funds restrict the termination power even further: investors have no right to replace managers, to whom they must commit their funds for at least ten years.⁴⁹ Meanwhile, corporations such as Google and Facebook have adopted dual-class share structures that prevent investors from replacing directors at all.⁵⁰ Agency-cost theory, in which investors hold control rights solely for the purpose of deterring managerial misconduct, cannot explain why investors would place their capital with firms possessing these governance structures.

⁴⁶ See, e.g., Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. (forthcoming 2017).

⁴⁷ See, e.g., Del. Code Ann. tit. 8, § 211(b).

⁴⁸ See, e.g., *id.* § 141(d).

⁴⁹ See Steve N. Kaplan & Per Stromberg, *Leveraged Buyouts and Private Equity*, 22 J. ECON. PERSPECTIVES 1 (2008).

⁵⁰ See Alphabet Inc., Annual Report (Form 10-K) (filed Feb. 1, 2016); Facebook, Inc., Annual Report (Form 10-K) (filed Jan. 28, 2016); Simon C.Y. Wong, *Google's Stock-Split Plan Would Replace Stewardship with Dictatorship*, HARV. BUS. REV. (Apr. 18, 2012), <https://hbr.org/2012/04/googles-stock-split-plan-would/> [<https://perma.cc/B8T9-6YBU>]; Facebook, Inc., Form 10-K and Brad Stone, *Facebook Will Form 2 Classes of Stock*, N.Y. TIMES (Nov. 24, 2009), <http://www.nytimes.com/2009/11/25/technology/internet/25facebook.html> 1 [<http://perma.cc/AW79-7FRP>]; James Surowiecki, *Unequal Shares*, NEW YORKER (May 28, 2012), <http://www.newyorker.com/magazine/2012/05/28/unequal-shares> [<http://perma.cc/R3AS-FUS3>].

The point can be seen in the context of the Jensen-Meckling model. All of the investor's control rights in that model serve to reduce agent conflict costs. The investor's exercise of any control right would, in the Jensen-Meckling framework, generate monitoring costs.⁵¹ But the possibility of monitoring costs would not justify restricting the investor's power to exercise control. The model assumes that the investor accurately estimates expected agent conflict costs and never makes mistakes in the exercise of control rights. Therefore, he will only exercise a control right, and incur the associated monitoring costs, when doing so reduces overall agency costs. In other words, he will only exercise a control right when doing so is efficient. For this reason, the model's logic supplies no reason to limit the investor's powers, including a power to fire and replace the manager at will.

A satisfying explanation for the governance-control spectrum becomes evident only when we take into account that investors can also generate conflict costs, and, more fundamentally, that both investors and managers can generate competence costs.

III. The Theory of Principal Costs

Principal-cost theory starts with the observation that the exercise of control in business firms generates both benefits and costs. To produce firm value—by which we mean the value of the goods or services that the firm produces, minus the cost of the resources it consumes in producing them—someone must exercise control over the firm. Regardless of whether that someone is

⁵¹ Under the assumptions of the original Jensen-Meckling model, a power to control the manager would not deter managerial misconduct because the model effectively assumes that managers are homogeneous in their propensity to shirk or divert. *See* Jensen & Meckling, *supra* note 1. Operating under this assumption, actually replacing the manager will not improve the firm's performance, and indeed will reduce its value due to the transaction costs associated with termination and replacement. For this reason, threats by the investor to terminate the manager will not be credible. In order for the termination right to be an effective monitoring device, we must assume that agents are heterogenous in their propensity to act disloyally, and that investors cannot know, at the time they hire the manager, that the manager's propensity is no greater than the propensity of other, equally competent manager candidates who might become available for hire.

investors, hired managers, or both, the creation of firm value requires that someone select the business strategy, and then execute it by hiring and firing employees, timing product launches, and so on. Both components—strategy and execution—require control. Therefore, the main benefit of control in business firms, exercised through the efficient use of effort, expertise, and talent, is the creation of firm value.⁵²

At the same time, however, the exercise of control generates costs that sap firm value. Control costs can be divided along two dimensions, one being the identity of the person whose actions are the source of the cost, and the other being the problem that explains the cost. In terms of whose actions are the source of the cost, we define principal costs as costs attributable to the exercise of control by investors, and agent costs as costs attributable to the exercise of control by managers. And in terms of the problem, we distinguish between “competence costs,” which we define as “the costs of honest mistakes plus the costs of efforts to avoid such mistakes,” and “conflict costs,” which we define as “the costs of self-seeking conduct plus the costs of efficient efforts to prevent such conduct.” We refer to *efficient* efforts to prevent self-seeking conduct because a cost resulting from, for example, overspending on monitoring—the incurring of \$100 in monitoring costs to prevent only \$50 in misconduct—would constitute a mistake, and thus should be considered a competence cost rather than a conflict cost.⁵³

⁵² Additionally, the process of creating enterprise value generates harmless non-pecuniary-benefits, such as the psychic enjoyment of exercising control. See, e.g., Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1663–64 (2006) (defining non-pecuniary private benefits of control as “forms of psychic and other benefits that, without more, involve no transfer of real company resources and do not disproportionately dilute the value of the company’s stock to a diversified investor”); Alessio M. Paces, *Control Matters: Law and Economics of Private Benefits of Control* 12 (ECGI-Law Working Paper Series No. 131/2009, 2009), <http://ssrn.com/abstract=1448164> [<http://perma.cc/T2MR-43RR>] (explaining how private benefits such as personal satisfaction can be cashed in on the market for corporate control). Although these non-pecuniary benefits are important, for ease of presentation, we do not discuss them here.

⁵³ Just as overspending on monitoring by the investor would constitute a

These two distinctions yield four categories of control costs: principal competence costs, principal conflict costs, agent competence costs, and agent conflict costs. A governance structure that maximizes firm value allocates control in the way that minimizes the sum of costs in these four categories. Any shift of control among principals and agents entails tradeoffs among the four categories, with the net effect of the shift—and thus the optimal control structure—depending on firm-specific characteristics.

Before we develop the implications of this framework, a definitional clarification is in order. When distinguishing between principals and agents, we generally intend to refer to the difference between investors and managers. But of course the boundary between these groups is not clean, as many firms have managers who have also contributed capital. One solution for us would be to define degrees of “principalness” and “agentness,” but we think this would introduce more complexity than it is worth. We keep things simple by defining an agent as a party whose share of the discretionary control rights exceeds his share of the cash-flow rights, and a principal as a party whose share of the cash-flow rights equals or exceeds his share of the discretionary control rights.⁵⁴ As applied to most corporate governance structures, these definitions are workable and accord with common usage. For example, in a public firm with dispersed ownership, the directors, in unity with management, are agents, and the shareholders are principals. But in a firm with a controlling shareholder (possessing a control block either of common shares⁵⁵ or of the vote-controlling shares in a dual-class structure⁵⁶), the controller is, in

principal competence cost, overspending on bonding by the agent would constitute an agent competence cost.

⁵⁴ This definition departs from the common law definition of a principal–agent relationship, which requires exercise of ultimate control by the principal as an “essential element.” RESTATEMENT (THIRD) OF AGENCY § 1.01, cmt. f (Am. Law Inst., 2005); *see also* Hollingsworth v. Perry, 133 S. Ct. 2652, 2666–67 (2013) (citing the *Restatement* for its control requirement). Under our definition, an investor who has no control rights would still be a principal, and the manager who administers the investor’s capital would still be an agent.

⁵⁵ *See generally* Goshen & Hamdani, *supra* note 9, at 591.

⁵⁶ *See generally id.* at 588–89.

unity with the board and the managers, the agent, while the non-controlling shareholders are the principals. To be sure, when the parties share control in a more complicated division between investors and managers, it becomes harder to determine who has more control rights than cash-flow rights, but such arrangements are not common enough to undermine the utility of the distinction we offer here.⁵⁷

We now elaborate upon each of the categories of control cost within our framework.

A. Competence Costs

Standard principal-agent models often skip over a threshold question: why does the principal hire the agent? If the investor can provide all the necessary capital, the investor could avoid the troublesome separation of ownership and control by running the firm as well. The suggestion that the manager's role in such a firm is to provide the business idea is inadequate,⁵⁸ as the investor could simply buy the idea from the manager. A more compelling explanation for the separation of ownership and control—the font of all conflict costs—is competence. Investors hire a manager who can run a business more competently than they can, generating greater firm value. Therefore, competence costs—or, more specifically, principal competence costs—are the problem that all governance structures are ultimately designed to solve.

1. Principal Competence Costs — By delegating control to managers, investors reduce principal competence costs, even while they increase agent costs. Delegation is efficient as long as the principal competence costs thereby avoided exceed the other types of control costs thereby created.

To illustrate this tradeoff, consider a hypothetical investor, Don, who wishes to use his considerable personal wealth to build a stock portfolio. Although Don could pick his stocks himself, he

⁵⁷ For example, if a holder of a non-controlling block within the principal group is able to affect the probability of a voting result (e.g., a holdout), she will still be considered part of the principal even though, with respect to the specific vote, her share of control exceeds her share of the cash-flow rights.

⁵⁸ See the papers cited *supra* note 45.

lacks knowledge of business and finance, and he is thus likely to make mistakes. He might pick stocks that are overpriced, he might fail to diversify, and he might incur avoidable taxes. None of these costs would result from a conflict of interests: Don would be managing his own money and therefore would internalize all benefits and costs of his actions. His mistakes would not, in other words, result from shirking or diverting. They would be *honest* mistakes, caused by a simple lack of competence. To reduce the expected costs of his own mistakes, Don could try to acquire the requisite expertise and information, but he would incur opportunity costs if he did.⁵⁹ Moreover, he might make honest mistakes due to cognitive shortcomings such as lack of objectivity and overconfidence,⁶⁰ which may be difficult to overcome even with an investment in greater information and expertise. The costs of the honest mistakes Don would make, as well as the costs of his efforts to make fewer mistakes in his exercise of control, would constitute competence costs.⁶¹ In particular, they would be principal competence costs, because Don is the principal in the enterprise whose function is to manage his stock portfolio.

To reduce principal competence costs, Don could hire Peggy, a stock-market expert, to manage his portfolio for him. Peggy's exercise of control will also generate costs, which we would call agent costs. She might make her own honest mistakes—generating agent competence costs—and she might act disloyally—generating agent conflict costs. Don will rationally hire Peggy and delegate control to her only if, by doing so, he expects the total control costs of managing his portfolio to fall. One condition of delegation is

⁵⁹ See generally Investopedia, *Opportunity Cost*, <http://www.investopedia.com/terms/o/opportunitycost.asp> (last visited Aug. 26, 2016) (explaining that opportunity costs are “benefit[s] that a person could have received, but gave up, to take another course of action”).

⁶⁰ See generally Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1084–1102 (2000) (explaining the effects of cognitive biases on behavior).

⁶¹ Legal scholars frequently cite differences in expertise and information as reasons why shareholders delegate authority to corporate boards. See, e.g., Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 792 (2002).

therefore that the drop in expected principal competence costs exceeds the resulting expected agent costs.

Importantly, the mere hiring of Peggy will not eliminate all principal competence costs. Don is likely to retain certain control rights, such as the right to fire Peggy if, in his view, his portfolio's performance is lackluster. If the portfolio's performance does indeed fall below the market benchmark, Peggy might then try to save her job by assuring Don that the underperformance is temporary, and that her carefully selected stocks will soon surge in value. At this point, Don might not know whether Peggy is brilliant and telling the truth, or is incompetent and lazy, covering weak performance with lies. In deciding between these possibilities, he might make an honest mistake. The very lack of competence in evaluating stocks that led him to hire Peggy may also impair his evaluation of her performance. He might retain her even though she is bungling or unscrupulous (a false negative), or he might replace her even though she is brilliant and honest (a false positive). Such accountability mistakes are another potential source of principal competence costs. To protect herself, Peggy might select a sub-optimal portfolio that will never outperform the market but never temporarily underperform it either, or a sub-optimal portfolio composed of stocks that can easily be explained to Don.⁶² The loss of value from such self-protective acts is a principal competence cost. Less drastically, Don might force Peggy to provide him with regular performance reports, even though they distract Peggy from doing her job and do little to improve Don's decision-making. The cost of such over-monitoring would constitute a principal competence cost as well. The implication is that, as long as principals retain powers to replace agents or otherwise hold them accountable, they will still generate principal competence costs.

The Don-Peggy relationship has permitted us to illustrate the sources of principal costs that will be present even if a firm has only one principal. When, however, principals exist as a group—as

⁶² See, e.g., Sunil Wahal & John McConnell, *Do Institutional Investors Exacerbate Managerial Myopia?*, 6 J. CORP. FIN. 307 (2000) (showing that "the presence of institutional shareholders allows managers to invest more in plant and equipment and R&D than would individual shareholders").

they do in a corporation with multiple shareholders—competence costs also arise due to the need to coordinate decision-making.⁶³ In that setting, there is a tradeoff between the principal costs that arise from collective decision-making and the agent costs that arise if control is concentrated in the hands of a few individuals, acting on behalf of the collective.

2. Agent Competence Costs — Agency-cost models tend to assume that when managers harm their firm, they always do so intentionally. But of course managers also make honest mistakes, generating agent competence costs. The level of cost will vary with the manager: intelligent, unbiased, and informed managers make fewer mistakes than dull, biased, and ignorant managers. Thus, if Peggy picks a bad stock because she used a flawed evaluation method, her mistake will be a source of agent competence costs. Similarly, if an overconfident corporate manager were too optimistic about a project,⁶⁴ her decision to fund the project could also generate agent competence costs. As we will discuss in Part III.E, the types of accountability mechanisms that principals use to reduce agent competence costs tend to differ from those used to reduce agent conflict costs.

3. A Firm's Total Competence Costs — The division of control between principals and agents in a firm determines the total level of competence costs, and the cost-minimizing division is determined by firm-specific characteristics. Because the probability of a mistake depends on the competence levels of individual decision-makers, investors who are knowledgeable about business matters will typically delegate less control to managers than those who are uninformed. In addition, competence can be activity-specific: a hedge-fund manager might be good at picking stocks and managing a portfolio but bad at running a

⁶³ These costs arise out of difficulties associated with coordinating multiple parties' efforts in service of their collective interest. See Hansmann, *supra* note 11.

⁶⁴ See Susanna Kim Ripken, *Predictions, Projections, and Precautions: Conveying Cautionary Warnings in Corporate Forward-Looking Statements*, 2005 U. ILL. L. REV. 929, 958–68. See generally Korobkin & Ulen, *supra* note 60, at 1091 (explaining the effect of overconfidence biases).

company; similarly, an entrepreneur might be good at identifying business opportunities but bad at managing people. We can expect organizations to allocate control accordingly.⁶⁵

Another important determinant of the probability of mistakes is the type of business. Mistakes are more likely in firms that are complex in terms of size, technology, or geography. Complexity makes honest mistakes more likely, and it creates challenges for investors in particular by making it harder for them to evaluate managerial performance.⁶⁶ Therefore, when a firm is in a complex industry, its investors are more likely to make mistakes in evaluating the managers' performance and deciding whether to replace them.⁶⁷ Similarly, when investors use a firm's public stock price as a performance proxy, market imperfections can distort prices in ways that induce investors to misjudge managerial competence and loyalty.⁶⁸

Besides differing in probability, control mistakes can differ in magnitude. One important determinant of a mistake's magnitude is the level of market competition, both in the product market and in the input markets where the firm acquires capital, materials, and employees. The same mistake could either bankrupt a firm or just

⁶⁵ See, e.g., Viral V. Acharya, Marc Gabarro, & Paolo F. Volpin, *Competition for Managers, Corporate Governance and Incentive Compensation* (April 2012) (unpublished manuscript) at <http://ssrn.com/abstract=2066309> (showing that in equilibrium "better managers end up at firms with weaker governance").

⁶⁶ See, e.g., Mustafa Ciftci et al., *Is Research and Development Mispriced or Properly Risk Adjusted?*, 26 ACCT., AUDITING & FIN. 81, 97–109 (2011) (presenting empirical evidence suggesting that investors undervalue firms with research-and-development spending); Andrei Shleifer & Robert W. Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV. 148, (1990) (showing that the stock market is likely to misprice complex new project).

⁶⁷ Managers will account for this risk by limiting investors' right to replace them. This can explain why we observe more dual-class structures among high-tech firms.

⁶⁸ Markets may become imperfect due to misvaluations (e.g., insufficiently informed trading) or limits on arbitrage (e.g., inefficient or myopic markets). See, e.g. Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 653 (2003); Victor L. Bernard & Jacob K Thomas, *Evidence That Stock Prices Do Not Fully Reflect The Implications of Current Earnings for Future Earnings*, 13 J. ACCT. & ECON. 305 (1990).

dent its profits, depending on whether the markets in which it operates are competitive or monopolistic.

As the expected cost (the magnitude multiplied by the probability) of a mistake increases, parties will be willing to expend more effort to prevent it, such as by acquiring expertise and information.⁶⁹ Some mistakes will, however, be unavoidable, in the sense that their expected cost will be less than the cost of avoiding them. Because mistakes can result from a manager's intellectual and emotional endowments, they might be tolerable if the manager is otherwise competent, or is especially good at an aspect of management that is important to the firm. But if the mistakes are unendurable, their prevention might necessitate curtailing the manager's control or replacing her altogether.

B. The Byproduct of Competence-Raising Delegation: Conflict Costs

Conflict costs, which are the fixation of agency-cost theory, are a secondary form of control costs, as they arise only when investors, in an effort to reduce competence costs, delegate control to agents. A sole proprietor who runs his own business generates competence costs but not conflict costs.⁷⁰ Rather, conflict costs—the result of intentional, self-seeking conduct in the operation of a business firm, namely shirking and diverting—arise only when control, cash flows, or both are shared among parties.

1. Principal Conflict Costs — Principal conflict costs result from self-seeking conduct by investors caused by the separation of ownership and control. They can arise even when a business relationship has just one principal.

⁶⁹ The business model of firms like McKinsey is built on this need. *See About Us*, MCKINSEY & COMPANY, <http://www.mckinsey.com/about-us/overview> (last visited Aug. 26, 2016) (“McKinsey & Company is a global management consulting firm that serves leading businesses, governments, non governmental organizations, and not-for-profits. We help our clients make lasting improvements to their performance and realize their most important goals. Over nearly a century, we’ve built a firm uniquely equipped to this task.”).

⁷⁰ *But see* ROBERT LEWIS STEVENSON, *STRANGE CASE OF DR. JEKYLL AND MR. HYDE* (1886). We assume that real-world actors do not suffer from internal conflicts of the Jekyll-and-Hyde variety.

Using the Don–Peggy undertaking for illustration, assume that the two agree to divide equally the cash flows from the portfolio that Peggy manages. This division encourages both parties to act unscrupulously. Just as Peggy faces incentives to shirk on the job and divert value from the portfolio to herself, Don has incentives to use his control to shirk and divert as well. For instance, assume Don and Peggy initially agree that, if the portfolio underperforms the market benchmark, Don has the option of firing Peggy. Assume further that, after six months, the portfolio is indeed underperforming. Peggy might aver that the underperformance is temporary, and that her carefully selected stocks will soon beat the market. Moreover, Don might believe that she is competent and loyal, and is thus telling the truth. But he still might fire her at this point so that he can capture 100% of the profits once the portfolio increases in value. Anticipating this possibility, Peggy might select a sub-optimal portfolio that will never outperform the market, but will never temporarily underperform it either. The lost value resulting from such self-protective conduct by a manager is a principal conflict cost, because it is ultimately caused by the possibility of self-seeking conduct by the investor.

When principals form a group, such as the dispersed shareholders of a public company, conflict costs result from conflict of interests within the group, such as when one sub-group seeks to extract value from another. Scholars have described several sources of such conflict among shareholders, including different investment horizons,⁷¹ different needs for cash payouts,⁷² empty voting,⁷³ and competing outside interests.⁷⁴ Additionally, when principals form a group, conflict costs arise from collective-action problems, such as holdout incentives,⁷⁵ rational apathy,⁷⁶

⁷¹ See José-Miguel Gaspar et al., *Shareholder Investment Horizons and the Market for Corporate Control*, 76 FIN. ECON. 135 (2005).

⁷² See Deborah Lucas & Robert McDonald, *Shareholder Heterogeneity, Adverse Selection, and Payout Policy*, 33 J. FIN. QUANT. ANALYSIS 233 (1998).

⁷³ Bernard Black & Henry T. Hu, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2005) (discussing the conflicts of investors when separating voting rights from equity ownership).

⁷⁴ See, e.g., Bainbridge, *supra* note 18.

⁷⁵ See Zohar Goshen, *Controlling Strategic Voting: Property Rule or*

rational reticence,⁷⁷ and strategic voting,⁷⁸ all of which are caused by the division of control rights among multiple parties.

To obviate principal conflict costs, investors often transfer control to a common agent.⁷⁹ As an illustration, suppose that a group of investors (not Don alone) hires Peggy to manage the group's money through an investment fund. Suppose further that Peggy has an idea for an investment project that would tie up the bulk of the investors' capital for several years, and would ultimately generate a higher return than any other project that the fund could pursue.⁸⁰ It is in the investors' collective interest for Peggy to pursue such a project. But suppose that, one year into the project, Don has ideas of his own: he wants an immediate cash distribution so he can send his daughter to an expensive boarding school. If Don could force such a payout, and the fund's only way to make the payout was to liquidate the long-term project prematurely, he could impose a loss on the other investors. Moreover, the loss might be large enough that Don would not force the liquidation if he had to bear the full loss himself. Therefore, his exercise of control rights would generate principal conflict costs. Anticipating such problems, the investors might collectively agree to waive their liquidation rights for fixed periods.⁸¹ But by waiving this control right, they would lose a device for holding Peggy accountable. If they nonetheless agreed to waive the right, the implication would be that they expected the consequent decrease in principal conflict costs to outweigh the consequent increase in expected agent costs.

Liability Rule?, 70 S. CAL. L. REV. 741 (1997) [hereinafter Goshen, *Controlling Strategic Voting*].

⁷⁶ See generally ADOLF BERLE & GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

⁷⁷ See Gilson & Gordon, *supra* note 37, at 889.

⁷⁸ See Lucian A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985); Jeffrey N. Gordon, *Ties that Bind: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1 (1988).

⁷⁹ See generally KENNETH ARROW, *THE LIMITS OF ORGANIZATIONS* (1974).

⁸⁰ See generally RICHARD BREALEY ET AL., *PRINCIPALS OF CORPORATE FINANCE* 101 (10th ed. 2011) (explaining the concept of "net present value").

⁸¹ Indeed, this is the common structure of private equity funds. See Kaplan & Stromberg, *supra* note 49.

The goal of reducing both principal conflict costs and principal competence costs similarly explains why investors in public corporations delegate control to managers. To see this, imagine a widely-held public corporation called Direct Democracy Company. Per its charter, any of its thousands of constantly changing shareholders may, at any time, use its website to propose change in its business strategy. Once a proposal appears, holders of a simple majority of shares could approve it by online voting.⁸² The corporation has managers, but their only task is to implement business plans endorsed by the shareholders. Circumscribing the managers' discretion in this way would undoubtedly limit agent costs. But how likely is it that Direct Democracy Company would succeed? Because its shares are widely held, its shareholders would naturally have dispersed views, conflicts of interests, and different investment horizons. They also would face collective-action and coordination problems, because most shareholders would own only a small fraction of the corporation, which each shareholder would view in the context of a diversified portfolio.⁸³

⁸² The Delaware General Corporation Law authorizes this type of governance structure for corporations, permitting the certificate of incorporation to provide for management directly by shareholders rather than the board. See Del. Code. Ann. tit. 8, § 141(a) (2016) (vesting management of the corporation's "business and affairs" in the board "except as may be provided in the certificate of incorporation," and further allowing management authority to be vested in "such person or persons as may be provided in the certificate as corporation"). For closely held corporations, Delaware law explicitly authorizes shareholder management, although it suggests various additional requirements. *Id.* at § 351. Some forms of business organization, such as the partnership and limited liability company, provide for management by partners or members as a default rule. See, e.g., UNIF. P'SHIP ACT § 401(f) (1997) ("Each partner has equal rights in the management and conduct of the partnership business."); REVISED UNIFORM LIMITED LIABILITY COMPANY ACT § 407(a)–(b) (providing that a limited liability company is "member-managed" by default and vesting "management and conduct" of member-managed companies "in the members").

⁸³ Individual investors, many of whom hold a small fraction of a wide variety of companies, will be rationally apathetic about management's decisions. While the rise of institutional investors, which hold large position in many companies and are devoted to overseeing their investments, might suggest a decline in this apathy, in fact these investors seem reticent to interfere with management. See Gilson & Gordon, *supra*

Further, the shareholders would not be privy to most of the relevant information possessed by the firm's managers, as posting all inside information on the company's website would compromise the firm's competitive position. Under such conditions, the two sources of principal costs—competence costs and conflict costs—would most likely consume all of the firm's potential value. It is thus unsurprising that widely-held firms never adopt this governance structure. Rather, structures in which equity investors exercise direct control over strategic decisions are seen only in sole proprietorships, small partnerships, and some closely held corporations. State law recognizes the costs of direct democracy in business corporations by vesting management of a corporation's business and affairs in the board of directors,⁸⁴ and federal law follows suit by permitting public firms to exclude shareholder proposals related to the company's ordinary business operations from the firms' annual proxy statements, even if framed in precatory terms.⁸⁵

As this discussion makes clear, the primary reason that firms—both large and small—delegate control to managers is to reduce principal costs. It is for this reason that we refer to the theory that we have introduced in this Article as “principal-cost theory.” Principal costs are the origin of all control costs in business firms, and they are the problem that all governance structures are ultimately designed to solve.

note 37, 889—95. Gilson and Gordon explain how institutional investors such as mutual funds and public funds undervalue their voting rights because of a divergence between their interest in relative firm performance and shareholders' interest in absolute performance. *See also* Kahan & Rock, *supra* note 37, at 1057–62 (citing low pay and incentives, political constraints, and conflicts of interest as factors that keep public funds from pursuing aggressive activist strategies).

⁸⁴ Del. Code. Ann. tit. 8, § 141(a); *cf.* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 557–59 (2002) (positing that centralized decisionmaking is a response to collective-action problems).

⁸⁵ 17 C.F.R. § 240.14a-8(i)(7) (2016); *see also* Reilly S. Steel, Note, *The Underground Rulification of the Ordinary Business Operations Exclusion*, 116 COLUM. L. REV. (forthcoming Oct. 2016), manuscript at 13 (arguing that the ordinary business operations exclusion tracks the distinction under state law between the roles of shareholders and managers).

2. Agent Conflict Costs — Agent conflict costs—which are what Jensen and Meckling, in disregard of competence costs, called simply agency costs—are byproducts of principal costs: they arise when investors, in order to reduce principal costs, delegate control. Corporate-law scholars have identified a wide variety of behaviors that are sources of agent conflict cost, including entrenchment,⁸⁶ merging for size,⁸⁷ merging for diversification,⁸⁸ excessive or inefficient pay,⁸⁹ self-dealing,⁹⁰ tunneling,⁹¹ and options backdating.⁹² All such actions are forms of shirking or diverting, and all occur because managers do not capture all of their firms' cash flows and thus do not bear the full costs of their decisions when they exercise control.

3. A Firm's Total Conflict Costs — What causes some firms to incur greater conflict costs than others? The expected volume of self-seeking conduct by investors and managers—and thus the magnitude of conflict costs—depends on these parties' incentives, opportunities, and proclivities. As Jensen and Meckling demonstrated, incentives depend on the allocation of cash-flow rights: the temptation to shirk and divert rises as one's share of cash flows falls.⁹³ A party's opportunity to misbehave, in turn, depends on the allocation of control rights,⁹⁴ the type of firm,⁹⁵ and

⁸⁶ See Andrei Shleifer & Robert Vishny, *Management Entrenchment: The Case of Manager-Specific Investments*, 25 J. FIN. ECON. 123 (1989).

⁸⁷ See William J. Baumol, *On the Theory of Expansion of the Firm*, 52 AM. ECON. REV. 1078 (1962).

⁸⁸ See Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL. J. ECON. 605 (1981).

⁸⁹ See Bebchuk & Fried, *supra* note 32.

⁹⁰ See Austin W. Scott, *The Fiduciary Principle*, 37 CAL. L. REV. 539 (1949).

⁹¹ See Vladimir A. Atanasov, Bernard Black & Conrad Ciccotello, *Unbundling and Measuring Tunneling*, 2014 ILL. L. REV. 1697.

⁹² See Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802 (2005).

⁹³ See Bebchuk & Fried, *supra* note 32.

⁹⁴ The scope of authority, the bonding and monitoring methods employed, and other forms of curtailing control can limit a party's ability to get away with shirking or diverting. As a party's control rights increase, so does his power to take. For instance, if a party has the right to withdraw

the level of market competition.⁹⁶ Finally, proclivities matter: some people are naturally more honest than others, or derive less pleasure from taking time off or flying in a private jet. Given that all these elements affect the probability and magnitude of self-seeking behavior, the expected sum of conflict costs is firm-specific. For conflict costs will be higher in a firm in a noncompetitive industry, in which investors have delegated most of the control rights, but only a small fraction of the cash-flow rights, to a manager who is dishonest and lazy. Opportunities to deter misconduct through monitoring and bonding, which are also sources of conflict costs, will generally be firm-specific as well.⁹⁷

money from the firm's bank account based solely on his own signature, he can take more money than if withdrawals require a co-signer. *See, e.g.,* Ricardo Alonso & Niko Matouschek, *Optimal Delegation*, 75 REV. ECON. STUD. 259 (2008) (offering a formal model of the delegation dilemma).

⁹⁵ For instance, firms that are "cash cows" offer many opportunities to divert tangible assets, whereas growth firms that own mostly intellectual property offer fewer opportunities to divert assets. *See, e.g.,* Michael Jensen, *Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 76.2 (1986).

⁹⁶ As a general principle, a monopolistic firm can survive higher levels of conflict costs than can a firm in a competitive market. *See, e.g.,* Julia Chou, Lilian Ng, Valeriy Sibilkov, & Qinghau Wang, *Product Market Competition And Corporate Governance*, 1 REV. DEV. FIN., 114 (2011) (finding that "product market competition has a substantial impact on corporate governance and that it substitutes for corporate governance quality" and that "the disciplinary force of competition on management is from the fear of liquidation"); Maria Guadalupe & Francisco Pérez-González, *Competition and Private Benefits of Control* (2010) (unpublished manuscript) at SSRN: <http://ssrn.com/abstract=890814> (finding that "product market competition can help in curbing private benefits of control").

⁹⁷ As the level of misconduct depends on the personal characteristics of the actor, the type of firm, and the level of market competition, so will be the efforts to reduce that level.

C. Synthesis: The Control-Cost Matrix

Figure One: Control Costs		
	Competence Costs	Conflict Costs
Principal	Lack of expertise Inadequate information Lack of intelligence Poor emotional control Coordination problems Cognitive myopia	Collective-action problems Reneging on promises Rational apathy Rational reticence Holdouts Empty voting Different horizons
Agent	Lack of expertise Inadequate information Lack of intelligence Poor emotional control Overconfidence bias Optimism bias	Shirking (reduced effort) Diverting (self-dealing) Option backdating Entrenchment Merging for size Merging for diversification Excessive or inefficient pay

Figure One lists specific sources of each of the four types of control cost. When a sole proprietor delegates no control to managers, the only potential control costs are principal competence costs, at top left in the figure. When investors form a group, such as in a partnership, principal conflict costs, at top right in the figure, are also possible. But if those investors delegate all control rights to a manager, such as in a foundation or trust,⁹⁸ principal costs are avoided, but agent competence costs and agent conflict costs (the two bottom cells in the figure) are possible. Finally, when investors share control with managers, as in most business

⁹⁸ See, e.g., Henry Hansmann & Steen Thomsen, *Managerial Distance and Virtual Ownership: The Governance of Industrial Foundations* (ECGI Finance Working Paper No. 467, 2013), <http://ssrn.com/abstract=2246116> (describing and analyzing industrial foundations' performance and functions).

corporations, the exercise of control can generate all four types of control cost.

Because control costs decrease firm value, and the allocation of control rights determines the level of control costs, the parties who share a firm's cash flows have a collective interest in selecting a governance structure that minimizes the sum of control costs across the four categories listed in Figure One. We thus can presume that, absent a market failure or prohibitive transaction costs,⁹⁹ each firm has a governance structure that is suitable for its firm-specific characteristics.

D. The Tradeoff between Principal Costs and Agent Costs

Control over a business firm is a fixed quantity of power. Any reallocation of control rights reduces the power of some parties and increases the power of others. Consider, for example, control over the firm's business plan. Business planning can be divided into three components: proposing the plan, adopting it, and implementing it. Investors could retain control over all three components, or they could delegate control over some or all components to managers. Moreover, if they delegate control to managers, they could still retain the right to select the managers themselves. Alternatively, they could delegate that right too, making management self-perpetuating. What investors cannot do, however, is retain full and final authority over particular decisions while simultaneously delegating full and final authority over those decisions to managers.¹⁰⁰ In this way, the allocation of control rights in a firm is a zero-sum proposition.

⁹⁹ See Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 467 (2001) (mentioning market failure as a possible cause of managerialism); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 769–70 (1995) (noting different types of market failure); Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15–19 (1960) (discussing the effect of transaction costs); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1404–05 (1985) (noting that, under conventional assumptions, performance of a contract will make all parties' being better off, unless there is a market failure).

¹⁰⁰ See ARROW, *supra* note 79.

While the division of control *rights* in a firm is zero-sum, the impact of that division on control *costs* is not. Some divisions are more efficient than others. We can conceptualize various divisions of control along a range that begins with 100% control for investors and ends with 100% control for managers. As investors delegate along this spectrum, transferring more control to managers, principal costs decrease but agent costs increase. Shifting control from managers to investors has the converse consequences. But the consequences of such movements on principal costs and agent costs need not offset: shifting control from investors to managers may decrease principal costs more than it increases agent costs. In theory, there is a point along the control spectrum where the sum of principal and agent costs is at a minimum, a point that is achieved by a particular governance structure, and that will vary across firms.

As an illustration, imagine a firm in which investors start with 100% of the control rights. The investors are considering whether to delegate 1% of the control rights to managers. Delegation would cause expected principal costs to fall—let us assume by \$100. And it would cause expected agent costs to rise, but perhaps not as much—let us assume by \$50. Therefore, delegation of 1% of control rights over the firm would increase firm value by \$50. It follows that the investors will favor the delegation, because, as holders of the cash-flow rights, they capture the increase in firm value that the delegation accomplishes.

Let us define the “delegation substitution rate” as the ratio of the increase in expected agent costs to the decrease in expected principal costs produced by an incremental transfer of control rights from investors to managers in a firm:

$$\text{Delegation Substitution Rate} = \frac{\text{Increase in Expected Agent Costs}}{\text{Decrease in Expected Principal Costs}}$$

Because of the unavoidable tradeoff between principal costs and agent costs, the delegation substitution rate will always be a positive number. When the rate is less than 1.0, more delegation to agents decreases expected control costs and therefore increases firm value. When the rate is above 1.0, more delegation increases expected control costs and therefore decreases firm value. In the

example from the previous paragraph, the delegation substitution rate was 0.5, favoring delegation.

It is possible that, in some firms, the delegation substitution rate remains below 1.0 across the entire delegation range. In such firms, we can expect investors to wish to delegate all control rights to managers, as the sum of principal costs and agent costs reaches its nadir when the managers have full control. Such firms would achieve their maximum value by selecting a governance structure that assigns a high degree of control to managers, such as a dual-class share structure.¹⁰¹

At the opposite extreme are firms in which the delegation substitution rate is greater than 1.0 throughout the delegation range. In such firms, any incremental delegation increases expected agent costs more than it reduces expected principal costs. Such firms minimize control costs by placing all control in the hands of their investors. If they were public companies, they would adopt a governance structure resembling a direct democracy.¹⁰² Because public companies never actually adopt such a structure, we can be confident that firms large enough to go public never have such a relationship between principal and agent costs. Instead, this relationship seems to be found exclusively in smaller firms, including sole proprietorships, and in partnerships in which the partners retain full control over business decisions.¹⁰³

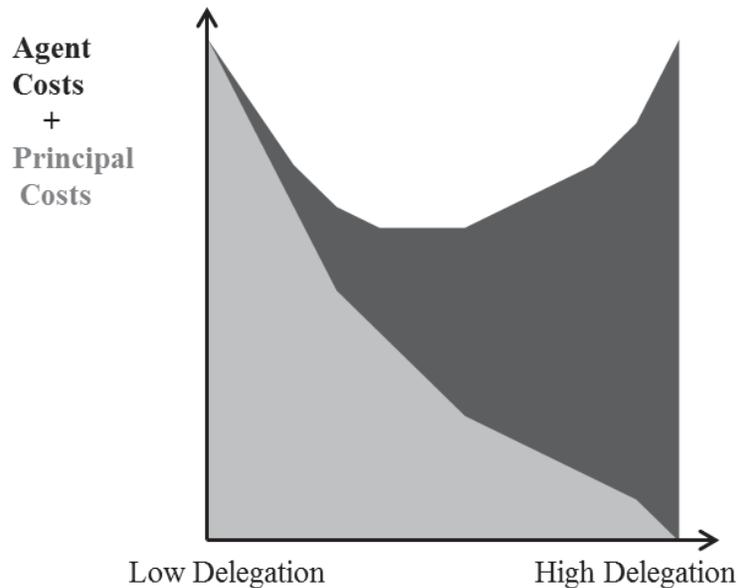
Finally, some firms have delegation substitution rates that are initially below 1.0 but that, as more control shifts to managers, eventually rises above 1.0. Figure Two depicts control costs in such firms.

¹⁰¹ Goshen & Hamdani, *supra* note 9, at 588–91 (explaining potential benefits of the dual-class structure for firms in which managerial “idiosyncratic vision” is important).

¹⁰² *See supra* section II.C.1.

¹⁰³ *See, e.g.,* Royston Greenwood, *The Professional Partnership: Relic or Exemplary Form of Governance?*, 24 *ORG. STUD.* 90 (2003) (explaining the success of professionals’ partnerships).

**Figure Two:
Cost Tradeoff Favoring Partial Delegation**



These firms maximize value by adopting a governance structure that delegates a large measure of control to managers, but also gives investors the power to hold managers accountable. One such structure is the corporation with dispersed ownership.¹⁰⁴

E. The Mechanics of Delegation

For ease of illustration, our discussion has described delegation as occurring along a single dimension, starting with full investor control and ending with full manager control. But delegation can occur along multiple dimensions. One such dimension is temporal: investors might give a measure of control to managers only for a fixed term. Delegation can also depend on the type of decision: investors might entrust managers with day-to-day operations but not strategic planning. In addition, investors can retain the power to select only some managers, such as a corporation's directors,

¹⁰⁴ See *infra* section II.G.3.

while allowing those managers to select the sub-agents, such as the CEO and other officers.

Delegation usually comes with strings attached. Investors almost never give managers unfettered discretion to dispose of a firm's assets and run its affairs. Doing so would be tantamount to making a gift to a foundation or trust.¹⁰⁵ Rather, investors retain powers to hold managers accountable and thus to reduce the agent costs that result from delegation. The control rights that investors retain can be divided, in our terminology, into discretionary rights and duty-enforcement rights. While discretionary rights have greater potential than duty-enforcement rights to reduce agent costs, they also entail higher principal costs.

Duty-enforcement rights are the more straightforward to define, and so we will discuss those first. When investors delegate power to managers, they often impose legally enforceable restrictions on the managers' exercise of control. For example, managers might be required to disclose conflicts of interest, refrain from self-dealing, and make decisions on an informed basis. Such obligations can be imposed by statute (such as a general incorporation law¹⁰⁶), by contract (such as a bond indenture with covenants¹⁰⁷), or by common law (such as through the law of fiduciary duties¹⁰⁸). Moreover, the obligation can take the form of a standard, such as the duty to act in good faith,¹⁰⁹ or a rule, such as a covenant that specifies a firm's maximum leverage ratio.¹¹⁰ A duty-enforcement right is a right to bring a lawsuit for breach of such an obligation. The remedy for violating the obligation can vary, but the process of its creation and enforcement is consistent: first, a duty is established; second, the agent breaches the duty; third, the principal sues. To prevail—to obtain the desired relief—the principal must establish, to the satisfaction of a court, that the agent indeed breached the pre-defined duty. Although principals have discretion over whether to seek relief, they do not have

¹⁰⁵ See Hansmann and Thomsen, *supra* note 98.

¹⁰⁶ See, e.g., Del. Code Ann. tit. 8, § 141.

¹⁰⁷ See Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

¹⁰⁸ See Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

¹⁰⁹ See *In re Walt Disney Derivative Litigation*, Case No. 411, 2005 (Del. June 8, 2006).

¹¹⁰ See Smith, *supra* note 107.

discretion about whether to *grant* relief: that discretion is vested in a court, which must decide whether the applicable duty or standard has indeed been violated.

The function of duty-enforcement rights is to reduce conflict costs. They are the rights that Jensen and Meckling likely had in mind when they discussed how the investor in their model might bargain for certain monitoring rights in order to reduce the direct costs of agent misconduct. Thus, prohibitions on self-dealing are meant to deter diverting, and requirements that agents act only in a well-informed manner (the traditional duty of care) aim to deter shirking. By contrast, duty-enforcement rights are generally ineffective at reducing competence costs, as it is more difficult to prove to a court that a firm's underperformance was due to unwise decisions rather than bad luck. The business judgment rule, with its judicial deference to managers who act in a disinterested and well-informed manner, reflects courts' unwillingness to involve themselves in matters of managerial competence, as contrasted with managerial loyalty.¹¹¹

The other category of control rights implicated in delegation decisions is discretionary rights. Paradigmatic examples are rights vested in the principal to select the agent and to fire and replace the agent at will. Shareholders exercise such discretionary rights when they vote incumbent directors out of office. Notably, shareholders who wish to elect new directors need not prove in court that the old directors violated some standard—that they self-dealt, acted in bad faith, or were objectively incompetent. The shareholders can act entirely on their own accord. Put another way, there is no distinction between seeking the relief and granting the relief: the shareholders' exercise of discretion encompasses both.

Another example of a discretionary right is the right that most general incorporation statutes give holders of a majority of a corporation's shares to veto a director-proposed merger, dissolution, or sale of all assets.¹¹² To veto such transactions,

¹¹¹ See Aronson, 473 A.2d at 811–13.

¹¹² See, e.g., Del. Code Ann. tit. 8, § 275 (2016) (providing for procedures of dissolution). Corporate charters can empower shareholders to veto other transactions as well. See, e.g., *id.* § 141(a). Conversely, investors can waive their right to veto even fundamental transactions by forming a limited liability company (LLC) and providing for this right in the

shareholders need not establish that the board proposed the transaction in bad faith or because of a conflict of interests; the shareholders may simply decide that the transaction would not be in their own best interests.

Discretionary rights can be collective or individual. We just mentioned two examples of collective discretionary rights: when shareholders elect directors or vote on proposed mergers, the will of holders of a majority of shares rules.¹¹³ An example of an individual discretionary right is the right to withdraw capital from a hedge fund or mutual fund.¹¹⁴ Each investor can exercise this right unilaterally, and purely at the investor's discretion: the investor need not first prove that the fund's managers violated an obligation or fell short of a standard of performance.

Like duty-enforcement rights, discretionary rights can be used to reduce agent conflict costs. But that is not their primary function. Rather, they are mainly used to police agent competence costs, as duty-enforcement rights are ill-suited to this task. The Jensen-Meckling model grants the investor no discretionary control rights precisely because the model assumes away competence costs: the model's manager can engage in disloyal conduct, but he never makes honest mistakes.

Because discretionary rights in the hands of investors can reduce both agent conflict costs and agent competence costs, they have greater potential than duty-enforcement rights for curbing total agent costs. But there's a catch: they also entail greater principal costs. Investors with the discretionary power to veto business plans proposed by the managers can make honest mistakes that reduce firm value. And, with discretionary power,

operating agreement. *See, e.g.*, REVISED UNIFORM LIMITED LIABILITY COMPANY ACT § 110 (2006) (providing that an LLC operating agreement may broadly alter default rules). State LLC statutes do not mandate investor ratification of any particular business transaction, instead permitting the parties to allocate this control right as they see fit. *See, e.g., id.*

¹¹³ *See, e.g.*, Goshen, *Controlling Strategic Voting*, *supra* note 75 (discussing strategic voting by shareholders and the majority rule).

¹¹⁴ *See* John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1252–54 (2014).

sub-group of investors can act as holdouts in order to extract value from other investors through abuse of the veto power.¹¹⁵

In contrast with discretionary rights, duty-enforcement rights are less disruptive, entailing lower principal costs but also less power to reduce agent costs. Their degree of disruptiveness depends on whether they can only be exercised at any time or only at periodic points. For example, a mandatory-dividend requirement, which is periodic in nature, does not interfere with the manager's power to select and implement the firm's business strategy. It merely limits the manager's control over profits, enabling the investor to decide whether to reinvest them with the agent or allocate them elsewhere. Similarly, fixed-term investments give managers unfettered discretion until the term ends, when the investor can decide whether to extend the agent's control over the investor's funds.¹¹⁶ Bond covenants, by contrast, often set continuous limits on managers' power to shape a firm's capital structure and operations, such as by restricting the issuance of new debt or prohibiting changes in the firm's line of business.¹¹⁷

As with the overall delegation question—implicating the tradeoff between principal costs and agent costs—the right tradeoff between discretionary rights and duty-enforcement rights is firm-specific. The parties who structure a firm, and who will either keep its cash flows for themselves or sell them to others, maximize their wealth when they select the governance structure that achieves the firm-specific allocation of control rights that minimizes total control costs.

F. Understanding the Governance Spectrum: Delegation and Accountability

The various governance structures that firms adopt differ along two broad dimensions: the degree to which they delegate control to managers, and the degree to which they enable investors to hold

¹¹⁵ See, e.g., *Schreiber v. Carney* 447 A.2d 17 (Del. Ch. 1982) (a company made a loan to a shareholder who controlled thirty-five percent of the company's stock in order to persuade him not to oppose a pending merger).

¹¹⁶ See Morley, *supra* note 114, at 1254–55 (discussing private equity fund exit rights).

¹¹⁷ See Smith, *supra* note 107.

managers accountable for the exercise of that control.¹¹⁸ In Part I, we observed that traditional agency-cost theory cannot account for either of these dimensions. It cannot explain why, even in wholly-owned firms, investors delegate authority to managers, as doing so creates agent conflict costs, the *bête noir* of agency theory. Nor can it explain why investors would ever agree to tie their hands, limiting their power to hold managers accountable. Principal-cost theory can explain both.

Under the principal-costs model, investors delegate to managers to reduce the competence costs, and sometimes conflict costs, that would be generated if they ran the firm entirely themselves. Even a principal who is a highly competent businesswoman might hire a manager to run one of her many small businesses if the opportunity cost to her of avoiding mistakes in running the business is higher than the manager's. In this way, a model of firm governance that contemplates principal competence costs can incorporate the economic theory of comparative advantage.

Principal costs also explain why investors would agree to restrictions on their powers to hold managers accountable. The most common such restriction is upon the power to fire managers. Shareholders in business corporations consent to a structure that permits them to replace directors only once a year, absent extraordinary circumstances. Agent-cost theory suggests that shareholders should want to retain the power to replace directors at any point. Once, however, principal costs are also taken into account, at-will director employment is no longer a self-evident ideal.

To see why shareholders would ever voluntarily tie their own hands, we start with the observation that the appearance of suboptimal performance by a business firm can have a variety of causes, not all of which call for replacing its managers. One potential cause is self-seeking managerial conduct (shirking or diverting), reflecting agent conflict costs. A second is imperfections in the performance measurement, such as short-term market mispricing of publicly traded shares.¹¹⁹ A third possibility

¹¹⁸ See ARROW, *supra* note 79.

¹¹⁹ See Aydoğan Altı & Paul C. Tetlock, *Biased Beliefs, Asset Prices, and Investment: A Structural Approach*, 69 J. FIN. 325 (2014).

is bad luck.¹²⁰ Finally, the suboptimal performance might be due to a pattern of honest managerial mistakes, reflecting agent competence. Only the last of these is clear grounds for firing the managers. If the managers are self-seeking but otherwise competent, the solution might instead be more monitoring and better pay-based incentives. Imperfect performance measurements, in turn, call for better instruments, while bad luck calls simply for patience. If investors always diagnosed the cause of underperformance accurately, and always acted prudently and honestly, there would be no reason for them to agree to limit or waive the power to fire managers. But most investors do not fit this description. They thus could misattribute disloyalty, bad measurements, or bad luck to incompetence, and then generate principal costs by firing a competent manager.

When investors are facing the question whether to replace a manager, a complicating factor is that the manager often has better knowledge than the investors about the causes of the firm's underperformance. In particular, the manager will know if he acted disloyally, and he will have a good sense whether the performance measurement is accurate. Because, however, the manager may be dishonest, the investor may not trust the explanations he offers. Therefore, investors will rationally expect managers to over-attribute poor performance to distorted measurements and bad luck, and under-attribute it to incompetence and disloyalty. In, however, second-guessing managers, investors will sometimes make honest mistakes: they will misdiagnose the cause of underperformance, and thus will replace managers who are, despite a firm's poor performance, in fact loyal and competent. Notably, the converse problem can also arise: incompetent investors might fail to fire an incompetent manager because good luck, or a distorted performance measure, makes the manager seem more competent than he is.

Anticipating the risk of false negatives—of being fired despite their competence—managers could respond in a variety of ways. They might demand higher salaries as compensation for the risk. They also might avoid profitable but complex business strategies

¹²⁰ In any particular context, even the wisest business strategy is likely to have some probability of failure.

that are prone to mis-measurement.¹²¹ In our hypothetical business relationship involving Don and Peggy, Peggy might refrain from picking undervalued stocks that will take time to appreciate in value, instead investing Don's capital in stocks that follow the market, or whose value can be easily explained. Finally, managers might simply refuse to work for investors whom they suspect are incompetent. None of these anticipatory responses by managers are good for investors, as all force investors to internalize the expected costs of their mistakes.

This discussion suggests that investors and managers have a common interest in selecting a governance structure that minimizes the expected sum of principal costs and agent costs. And this optimal structure may involve the investors' agreeing to tie their own hands.¹²² For example, the investors might agree to give the manager a long period during which the manager cannot be fired without cause, emboldening the manager to pursue long-term projects that are subject to short-term mis-measurement.¹²³

A desire to avoid principal conflict costs is a second reason why investors might agree to limits on their power to replace managers. For example, Peggy might refuse to work for Don, despite an offer of 50% of the returns from the portfolio while she manages it, if she fears that Don will opportunistically fire her after she selects a high-value portfolio in order to capture 100% of the continuing earnings. Don might then find it beneficial to guarantee Peggy employment for a minimum period. In essence, Don would be bonding himself to Peggy, with the expectation that the bonding

¹²¹ See, e.g., Mustafa Ciftci, *Do Analysts Underestimate Future Benefits of R&D?*, 5 INTER. BUS. RES. 26 (2012) (finding that "analysts underestimate earnings long term growth in R&D-intensive firms").

¹²² Justice Jacobs has suggested amending state corporate law to allow companies to abolish annual shareholder elections of the board of directors in favor of a three-or five-year board. Jack B. Jacobs, "*Patient Capital*": *Can Delaware Corporate Law Help Revive It?* 68 WASH. & LEE L. REV. 1645, 1648 (2011).

¹²³ In some firms, the investors may require some form of compensation for this voluntary surrender of power. But even when this is true, a mutually agreeable bargain will be possible as long as the value to the manager of non-interference exceeds the value that the investors place on the power to interfere. Such a bargain will be possible if, for example, the manager believes he is more competent or loyal than the investors perceive him to be.

cost is less than the other principal conflict costs thereby avoided. Similarly, in a firm with multiple investors, conflicts between those with short horizons and those with long horizons would generate principal conflict costs. Such would occur if the short-termers pressured management to run the firm in a way that temporarily boosted its stock prices but reduced its long-term value.¹²⁴ By restricting the investors' ability to replace managers except after long intervals, or by eliminating that right altogether, the investors could reduce such conflict costs.

Expected principal costs and agent costs will, in the negotiation between investors and management, determine whether, and over what intervals, the investors have the power to replace the

¹²⁴ Scholars and other commentators have vociferously debated whether, and to what extent, this conflict exists in public corporations, presenting both theoretical models and empirical evidence. *See, e.g.*, Bebchuk, *The Myth*, and Bebchuk, *Long Term*, *supra* note 39 (rejecting the short termism claim); Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 26, 2013 9:22 AM) (advocating the short-termism claim); Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 1005 (2013) (“Overall, the evidence that financial markets are excessively short-term is widely believed but not proven, and there is much evidence pointing in the other direction.”); Jeffrey C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655, 655–56 (1989) (presenting a game-theoretic model in which, if markets infer positive values from certain observable managerial signals and manipulation of those signals is not easily detected, managers have an incentive to manipulate the signals to enhance stock prices); Adam Brandenburger & Ben Polak, *When Managers Cover Their Posteriors: Making the Decisions the Market Wants to See*, 27 RAND J. ECON. 523, 526–27 (1996) (explaining myopia as a function of information asymmetries between managers and shareholders); Brian J. Bushee, *Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value?*, 18 Contemp. Acct. Res. 207 (2001) (finding that high levels of transient ownership are associated with an over-weighting of near-term expected earnings); The empirical debate has yet to produce a clear winner. *See* John C. Coffee Jr. & Darius Palia, *The Impact of Hedge Fund Activism: Evidence and Implications* (Colum. L. & Econ. Working Paper No. 489, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2496518 (reviewing various studies and concluding that the extent of short-termism is unclear). Nevertheless, the phenomenon is at least theoretically possible and serves as a useful example of how the potential for principal costs could cause investors to wish to tie their own hands.

managers. Shorter intervals—the extreme form of which is employment at will—correspond to lower expected agent costs but higher expected principal costs; longer intervals—the extreme form of which is lifetime employment—will have the converse consequences. In this way, principal-cost theory provides an explanation for why we observe in the economy a range of governance structures that differ in (among other features) the frequency with which they allow investors to replace managers.

G. Structures Along the Spectrum

The degrees of control that investors can exercise over managers produce a spectrum of governance structures. At one pole we find the investor-controlled “direct democracy”; at the other, the manager-controlled corporation with dual-class shares.¹²⁵ The dispersed-ownership structure, the most common arrangement among American public companies, falls in the middle. We discuss here three of the most important governance structures that public firms adopt, and we assess the tradeoff between principal costs and agent costs that each entails.¹²⁶ Other common governance arrangements, such as the standard private-equity fund, and the traditional partnership, could be slotted at various points along the spectrum.

1. The Dual-Class Share Structure — In a corporation with dual-class shares, the controlling managers own shares with superior voting rights, while outside investors hold shares with inferior voting rights.¹²⁷ Google and Facebook are notable firms

¹²⁵ See Goshen & Hamdani, *supra* note 9.

¹²⁶ Market failure may also explain why some firms allocate control rights differently from others. For example, managers may sometimes be able to acquire control rights beyond what is efficient because of informational asymmetries. See generally Joseph E. Stiglitz, *Information and the Change in the Paradigm in Economics* (Dec. 8, 2001), http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2001/stiglitz-lecture.pdf (explaining the role of informational asymmetries in economic analysis). Thus, a manager might be able to convince investors that a high degree of delegation is appropriate by withholding critical information that would show that he is not as honest or talented as investors perceive him to be.

¹²⁷ As an illustration, imagine a firm with Class A shares that have 51% of the votes but only 10% of the residual cash-flow rights, and with Class B

that went public with this structure.¹²⁸ Outside shareholders in such firms cannot interfere with business decisions or replace the board. And, while they can sell their shares, the outside shareholders cannot withdraw their investments from the firm.¹²⁹ For these reasons, neither activist hedge funds nor hostile raiders can force the managers of a dual-class firm to change its business strategy.¹³⁰

In the absence of direct control mechanisms, investors in such firms discourage self-seeking managerial conduct by giving the managers a large share of the cash flows—on average 40%.¹³¹ Still, because of the relatively low equity stake owned by the controlling managers, we can expect potential agent costs to be high in dual-class firms.¹³² On the other hand, potential principal costs are minimal, as managers enjoy complete freedom to pursue their strategic visions without fear that investors will mistakenly attempt to fire them for poor performance even though they are, in fact, performing well.¹³³ The structure may thus be well-suited to

shares that have 49% of the vote but 90% of the residual cash-flow rights. The manager-agent would own the Class A shares and the investor-principals would own the Class B shares.

¹²⁸ See Simon C.Y. Wong, *Google's Stock-Split Would Replace Stewardship with Dictatorship*, HARV. BUS. REV. ONLINE (Apr. 18, 2012), http://blogs.hbr.org/cs/2012/04/googles_stock-split_plan_would.html.

Google and Facebook are unusual dual-class firms in that their managers have only a small share of the equity (claims on profits). See Dan Bigman, *Facebook Ownership Structure Should Scare Investors More than Botched IPO*, FORBES (May 23, 2012) <http://www.forbes.com/sites/danbigman/2012/05/23/facebook-ownership-structure-should-scare-investors-more-than-botched-ipo/> (“[Zuckerberg] owns about 18% of the company, but controls more than 50% of the voting power.”).

¹²⁹ Sales of shares in the secondary market do not reduce a firm’s capital; they merely shift equity from some owners to other. By contrast, the withdrawal of capital by an investor shrinks the pool of assets under management’s control.

¹³⁰ But see Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. BUS. L. REV. 60, 90–95 (presenting and analyzing evidence of activist interventions in dual-class firms).

¹³¹ See, e.g., Paul A. Gompers, Joy Ishii, & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051 (2010).

¹³² See, e.g., Masulis, R.W., C. Wang, & F. Xie, 2009, *Agency Problems at Dual-Class Companies*, 64 J. FIN. (2009).

¹³³ See, e.g., Goshen & Hamdani, *supra* note 9 (exploring the benefits of

firms in complex industries, such as information technology, or to firms whose outside shareholders recognize management's unique skills and strategic vision. It is nonetheless an extreme option on the governance-structure menu, and it is rare among public firms in the United States.¹³⁴

2. The Concentrated-Ownership Structure — In a firm with concentrated ownership, a single entity (or bloc of investors) controls the corporation, which may be publicly listed, by virtue of owning a large number of common shares. Unlike in the dual-class share structure, there is no division between control rights and cash-flow rights; the controllers own equal portions of both. Thus, unlike the dual-class structure, the concentrated-ownership structure adheres to the principle of one share, one vote.¹³⁵ Control is not contestable unless the control bloc holds less than 50% of the shares. The bloc acts as an agent of minority investors, and can either directly manage the corporation or appoint professional managers, whom it can replace at will.

When an agent's control is incontestable, potential principal costs are low but potential agent costs are high. The dual-class structure and the concentrated-ownership structure have this distribution of costs in common. The two structures diverge, however, insofar as potential agent costs will be lower under the concentrated-ownership structure because the control bloc typically owns a larger proportion of the firm's cash-flow rights (50% or more) than do the managers of a dual-class firm (who, as

protecting managers' "idiosyncratic vision"); Belén Villalonga & Raphael Amit, *Family Control of Firms and Industries*, 39 FIN. MGMT. 863 (2010) (testing what explains family control of firms and industries and finding that "the explanation is largely contingent on the identity of families and individual blockholders" and that "founders and their families are more likely to retain control when doing so gives the firm a competitive advantage, thereby benefiting all shareholders.").

¹³⁴ See Robert M. Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83 (2001) (finding that only 6% of IPO firms have dual-class shares); Gompers, Ishii & Metrick, *supra* note 131 (noting that only about 6% of publically traded firms in the United States have dual-class structure).

¹³⁵ See, e.g., Sanford J. Grossman & Oliver D. Hart, *One Share-One Vote And The Market For Corporate Control*, 20 J. FIN. ECON. 175 (1988) (analyzing the conditions for the optimality of one share one vote).

noted, own about 40% on average). It is probably for this reason that the concentrated-ownership structure is more common.¹³⁶ But the dual-class structure does have one relative advantage: it allows managers to sell a larger proportion of the firm's cash-flow rights to outside investors without compromising their complete control. Therefore, if the managers' personal wealth is limited, and they wish to retain incontestable control, the dual-class structure enables them to raise more capital and thereby achieve greater economies of scale. In this way, the choice between the dual-class and concentrated ownership structures will often entail a tradeoff between economies of scale and agent costs.

3. The Dispersed-Ownership Structure — Notably, the two governance structures discussed so far do not enable outside investors to oust managers. Investors in firms with those structures can sell their interests, but they have little “voice.” The right to fire managers does not emerge on the governance spectrum until we reach the dispersed-ownership structure, the most common structure among public corporations in the United States.¹³⁷

While other governance structures may give managers full control—either indefinitely (as in a dual-class firm) or for a fixed period (as in a private equity fund)—investors can contest control of a dispersed-ownership firm through their voting rights. The structure entrusts managers to make the day-to-day business decisions (normally the CEO's realm of authority)¹³⁸ as well as major strategic and governance decisions (the board's realm of authority).¹³⁹ But shareholders can veto decisions by the board to merge the firm, sell all its assets, or dissolve it,¹⁴⁰ and they can

¹³⁶ Concentrated ownership is the prevalent structure around the world, *see*, Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

¹³⁷ *See, e.g.*, Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. FIN. 1301 (2003); La Porta, et al., *id.*

¹³⁸ *See* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.01 (Am. L. Inst., 1994).

¹³⁹ *See id.* § 3.02; *cf.* Del. Code Ann. tit. 8, § 141(a) (2016) (setting expansive board authority as a default rule).

¹⁴⁰ *See* Del. Code Ann. tit. 8, § 271 (requiring shareholder ratification of a board's proposal to sell substantially all of the corporation's assets); *id.* §

alter the business plan by replacing the directors. The structure therefore entails lower potential agent costs, but higher potential principal costs, than either the dual-class share structure or the concentrated ownership structure.

A shareholder who wishes to change the direction of a corporation with dispersed ownership normally follows either of two strategies. One strategy, pursued by hostile raiders, is to assemble a control block. Raiders begin a control contest by buying a toehold — about 10% of the outstanding shares—on the open market.¹⁴¹ Then, to expand that stake into a majority of shares, they make a tender offer that offers the other shareholders a premium over the market price. If the offer is successful, the raider can use the voting power appurtenant to the control block to replace the board and implement a new business plan. Alternatively, the raider can decide that the incumbent managers' business vision is fundamentally sound, in which case he can leave the managers in place and reap the profits from the course they were already pursuing.

The other shareholder strategy for challenging the direction of a corporation with dispersed ownership is to persuade holders of a majority of shares to support the challenger's proposal in a proxy contest. This is the strategy pursued by activist hedge funds.¹⁴² Like raiders, activist funds typically begin a control contest by acquiring a toehold stake through the stock market. But instead of then making a tender offer, activists initiate, or threaten to initiate, a proxy contest in which they ask other shareholders to support their proposals to replace incumbent directors, increase dividends, or change the firm's capital or governance structure.

The possibility that a raider or activist fund will contest control of a firm keeps agent costs in check. But because raiders and activists sometimes mistakenly target firms whose managers are in fact competent and loyal,¹⁴³ the dispersed ownership structure—which makes control contests possible—also entails significant principal costs.

251 (requiring majority shareholder approval of mergers).

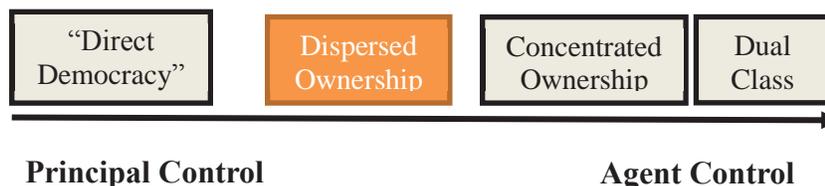
¹⁴¹ See, e.g., Ronald Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982).

¹⁴² See Kahan & Rock, *supra* note 37.

¹⁴³ See Coffee & Palia, *supra* note 124.

Figure Three places governance structures on a spectrum featuring a range of possible trade-offs between principal costs and agent costs.

**Figure Three:
The Governance-Structure Spectrum**



Agency-cost theory suggests that these governance structures should be arranged vertically according to their quality, with the structure that minimizes agent conflict costs (“Direct Democracy”) occupying the top position, and the one that maximizes them (dual-class shares) at the bottom. Under principal-cost theory, by contrast, no structure is inherently superior or inferior, as each offers a distinct tradeoff between principal costs and agent costs that may be ideal for a particular firm.

IV. Principal-Cost Theory Versus Agency-Cost Theory: Implications

Not only does principal-cost theory explain governance structures that agency-cost theory cannot, but its more comprehensive account of the factors that shape those structures also yields better empirical predictions, and wiser policy prescriptions. The list of possible implications is extensive; we limit ourselves here to commenting on those relating to several of the most important controversies in corporate law currently.

A. Empirical Predictions

Agency-cost theory predicts that, because some governance structures are inherently superior to others, firms that adopt them will consistently generate more value. The superior structures are those that, at any place where governance structures can differ, exhibit the feature that most empowers shareholders to exercise

control and hold managers accountable. If a real firm adopts a structure that falls short of this ideal, the explanation is itself agency costs: its managers have abused their power by selecting a governance feature that sacrifices firm value to their private interests.¹⁴⁴

Principal-cost theory makes a different prediction. Parties do not structure firms to minimize agency costs; rather, they structure them to minimize the sum of agent costs and principal costs, a firm-specific undertaking. Therefore, there should be no consistent correlation across firms between returns to investors and a particular structural feature. If such a correlation is found, it is firm-specific attributes, not the particular structural feature, that explain the difference in value. Once a study properly controls for those attributes, the apparent correlation should disappear.

The two theories also make different predictions about what will happen to firms when legal reform requires them to adopt a particular structural feature. Agency-cost theory suggests that such reform will *increase* average firm value if the mandatory feature empowers shareholders, but *decrease* average firm value if it disempowers them. Principal-cost theory predicts that such reform will *always* cause an initial drop in firm value. Firms that would benefit from the feature will have adopted it already; the law therefore imposes the feature only on firms for which it is inefficient, driving down their values. But the loss should only be *temporary*, as firms can reduce the impact of a mandatory rule by altering other structural features, their capital structures, and attributes such as their choice of business strategy. Therefore, the initial spike in control costs (and thus loss of overall firm value) will abate over time, and in some firms could disappear altogether. Agency-cost theorists, by contrast, usually take a static view: if a change in the law disempowers shareholders, the resultant loss of value will generally be *permanent*.

A final difference in predictions applies to legal reform that permits, but does not require, firms to adopt a new structural feature. If the new option enables firms to disempower shareholders, agency-cost theory suggests that self-interested managers will cause their firms to adopt it, driving down average

¹⁴⁴ See, e.g., Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006).

firm value. If, on the other hand, the new option empowers shareholders, firms will shun it, and so the reform will have little effect. The implication is that shareholder-empowering reform must be mandatory to be effective.¹⁴⁵ Principal-cost theory, by contrast, suggests that the appearance of a new option on the governance-structure menu will always increase average firm value. Firms for which the new option is disadvantageous will not adopt it, but firms that would benefit will adopt it, exploiting the opportunity to decrease control costs by better tailor their governance structures to their particular attributes.

With these general predictions in mind, we now survey several topics in corporate governance that empiricists have studied. For each topic, we consider whether the empirical results favor agency-cost theory or principal-cost theory. Given the numerous subjects and studies in the corporate-governance literature during the last forty years, during which agency-cost theory has dominated, our survey is necessarily abridged. We nonetheless believe it is fair to say that the trends in the studies, in which there are conflicting results in every topic, favor the predictions of principal-cost theory.

1. The Division of Cash Flows — According to the Jensen–Meckling model, allocating more of a firm’s cash flows to its managers decreases agency costs. Based on this observation, agency-cost theorists predict that firms in which management holds more equity will have higher values. Principal-cost theory yields a different prediction. Granting more cash flows to managers reduces agent conflict costs but increases principal conflict costs. Given this tradeoff, firms will tailor their division of cash-flow rights to their specific attributes and governance structures, yielding no general relationship between the division of cash flows and firm value.

When the question has been investigated empirically, some studies have found that firm performance and value varies depending on changes in management’s share ownership, from

¹⁴⁵ Or at least the default should be an opt-out provision. *See, e.g.*, Lucian A. Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489 (2002) [hereinafter Bebchuk & Hamdani, *Optimal Defaults*].

which the studies' authors conclude that some arrangements are superior to others, as agency-cost theory predicts.¹⁴⁶ When, however, these studies are corrected for missing controls and other problems, the relationship between the division of cash flows and firm performance tends to disappear, as principal-cost theory predicts.¹⁴⁷

2. Dual-Class Shares — Relative to the dispersed ownership structure, the dual-class share structure gives more power to directors, making it harder for outside shareholders to hold management accountable. Agency-cost theorists therefore predict that firms with dual-class shares will perform poorly.¹⁴⁸ Taken as a whole, however, the empirical studies do not support this claim.¹⁴⁹

¹⁴⁶ See, e.g., Randall Morck, Andrei Shleifer & Robert W. Vishny, *Management Ownership and Market Valuation*, 20 J. FIN. ECON. 293 (1988) (finding that firm's value "first increases, then declines, and finally rises slightly as ownership by the board of directors rises"); John McConnell and Henri Servaes, *Additional Evidence On Equity Ownership and Corporate Value*, 27 J. FIN. ECON. 595 (1990) (finding that "corporate value is a function of the structure of equity ownership"); Benjamin E. Hermalin and Michael S. Weisbach, *The Effects of Board Compensation and Direct Incentives on Firm Performance*, 20 J. FIN. MGM'T. 101 (1991) (same); Clifford Holderness, Randall Kroszner, and Dennis Sheehan, *Were the Good Old Days that Good?: Evolution of Managerial Stock Ownership and Corporate Governance since the Great Depression* 54 J. FIN. 435 (1999) (same).

¹⁴⁷ See, Charles Himmelberg, Glenn Hubbard, and Darius Palia, *Understanding the Determinants of Managerial Ownership and the Link Between Ownership and Performance*, 53 J. FIN. ECON. 353 (1999) ("after controlling both for observed firm characteristics and firm fixed effects, we cannot conclude (econometrically) that changes in managerial ownership affect firm performance"); Harold Demsetz and Kenneth Lehn, *The Structure Of Corporate Ownership: Causes And Consequences*, 93 J. POL. ECON. 1155 (1985) (finding that "the structure of corporate ownership varies systematically in ways that are consistent with value maximization."); Harold Demsetz and Belén Villalonga, *Ownership Structure and Corporate Performance*, 7 J. COR. FIN. 209 (2001) (finding "no statistically significant relation between ownership structure and firm performance.").

¹⁴⁸ See, e.g., Bebchuk, Kraakman & Triantis, *supra* note 4.

¹⁴⁹ See, e.g., Megan Partch, *The Creation of A Class Of Limited Voting Common Stock and Shareholder Wealth*, 18 J. FIN. ECON. 313 (1987) ("There is no evidence that current shareholders are harmed by the

While some have linked the dual-class structure to lower firm value,¹⁵⁰ others have found no correlation once firm-specific attributes are taken into account, as principal-cost theory predicts.¹⁵¹ In addition, studies have found that firms which *switch* from dispersed ownership to dual-class shares experience an increase in value, a result that principal-cost theory can explain but agency-cost theory cannot.¹⁵²

creation of limited voting common stock.”); Renée Adamsa & João Santos, *Identifying The Effect of Managerial Control On Firm Performance*, 41 J. ACCOUNT. & ECON. 55 (2006) (“Contrary to the belief that managerial control is purely detrimental, we find that it has positive effects on performance over at least some range.”);

¹⁵⁰ See, e.g., Ronald Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697 (2009) (finding that “managers with greater excess control rights over cash flow rights are more prone to pursue private benefits at shareholders’ expense,” and that “firm value is decreasing in insider excess control rights.”); Paul Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Companies in the United States*, 23 REV. FIN. STUD. 1051 (2010) (finding that in “single-stage regressions, we find strong evidence that firm value is increasing in insiders’ cash-flow rights and decreasing in insider voting rights” and that in “instrumental variable regressions, the point estimates are similar but the significance levels are lower.”); Scott Smarta, Ramabhadran Thirumalaib & Chad Zutter, *What’s In A Vote? The Short-And Long-Run Impact of Dual-Class Equity On IPO Firm Values*, 45 J. ACCT. & ECON. 94 (2008) (finding that “relative to fundamentals, dual-class firms trade at lower prices than do single-class firms, both at the IPO and for at least the subsequent 5 years,” and that “when duals unify their share classes, statistically and economically significant value gains occur.”).

¹⁵¹ Boehmer Ekkehart, Sanger Gary & Varshney Sanjay, *The Effect of Capital Structure and Consolidated Control on Firm Performance: The Case of Dual-Class IPOs*, in *EMPIRICAL ISSUES IN RAISING EQUITY CAPITAL* (Mario Levis, ed. 1995) (finding that dual-class IPOs “outperform their matched single-class counterparts in terms of stock-market returns as well as accounting measures of firm performance” and concluding that “going public with a dual-class equity structure has net benefits for investors in those firms that choose this specific organizational structure, as evidenced by better operating performance and larger equity returns relative to other IPOs.”)

¹⁵² Dimitrov Valentin & Jain Prem, *Recapitalization of One Class of Common Stock into Dual-class: Growth and Long-run Stock Returns* (Sept. 1, 2004) (unpublished manuscript), <http://ssrn.com/abstract=422080> (finding “that dual-class recapitalizations are shareholder value enhancing corporate initiatives” and showing that

3. Takeovers — Agency-cost theorists have voiced nearly unanimous support for hostile takeovers as a device for disciplining managers.¹⁵³ The stronger version of this view holds that boards should be completely passive when threatened by raiders, with no recourse to defensive measures.¹⁵⁴ A more moderate view allows defensive measures, but only for facilitating an auction of the target.¹⁵⁵

Principal-cost theory suggests a less starry-eyed view of hostile raiders. By aggregating shareholder control in the hands of a raider, a hostile tender offer does indeed reduce agent costs. At the same time, however, allowing shareholders to accept a tender offer without board approval could generate principal costs. If the shareholders fail to appreciate the true value of the incumbent managers' strategy, they could tender at an inadequate price, generating principal competence costs.¹⁵⁶ Similarly, groups of shareholders who would tender their shares because they prefer short-term profits at the expense of long-term investment might generate principal conflict costs by inducing the firm's managers to take expensive self-protective measures.¹⁵⁷ Permitting hostile

“stockholders, on average, earn significant positive abnormal returns” following the announcement of the recapitalization, and concluding that “we do not find any evidence of managerial entrenchment.”); Kenneth Lehn, Jeffrey Netter & Annette Poulsen, *Consolidating Corporate Control: Dual-Class Recapitalizations Versus Leveraged Buyout*, 27 J. FIN. ECON. 557 (1990) (finding that dual-class recapitalizing firms grow faster than firms in a control group and undertake secondary equity offerings to finance growth, and concluding that “these results increase our understanding of the causes of change in organizational form by illustrating that the method and effects of consolidating corporate control are systematically related to firm attributes.”).

¹⁵³ The leading voice is Henry G. Manne, *Cash Tender Offers for Shares: A Reply to Chairman Cohen*, 1967 DUKE L.J. 231 (1967); see also Bebchuk, *supra* note 78; Easterbrook & Fischel, *supra* note 33; Gilson, *supra* note 33.

¹⁵⁴ See Easterbrook & Fischel, *supra* note 33.

¹⁵⁵ See Gilson, *supra* note 141.

¹⁵⁶ Cf. Bernard Black & Reiner Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 529-33 (2002) (rejecting the claim of hidden value).

¹⁵⁷ See, e.g., Brian J. Bushee, *The Influence of Institutional Investors on Myopic Investment Behavior*, 73 ACCT. REV. 305 (1998) (arguing that a high level of institutional ownership by institutions exhibiting high

takeovers could thus increase or decrease overall control costs, with the effect varying by firm based on factors such as the personal characteristics of managers and shareholders, and the firm's industry and competitive environment.¹⁵⁸ For firms whose management is untrustworthy and whose business is easy for shareholders to understand, allocating control over takeovers to shareholders may reduce total control costs. But for firms whose management is trustworthy and whose business is difficult for shareholders to understand, allocating control to boards may be more efficient.

The same general analysis applies to specific takeover defenses. Consider, for example, poison pills, which impose prohibitive costs on raiders who acquire a large stake in a firm without board approval.¹⁵⁹ To circumvent a pill, a raider must take control of the target's board through a proxy fight, but this takes time and money. The pill thus increases board power relative to shareholder power, leading agency-cost theorists to condemn it as an entrenchment device that increases agency costs and thus reduces firm value.¹⁶⁰ But a pill can also reduce principal costs. Forcing raiders to wage proxy fights can reduce collective-action problems among shareholders,¹⁶¹ and the pill's capacity to encourage competing bids reduces the risk that an acquirer will induce shareholders to tender at an inadequate price.¹⁶² Once

portfolio turnover, diversification, and momentum trading significantly increases managerial incentives to pursue short-term projects).

¹⁵⁸ See, e.g., F. M. Scherer, *Corporate Takeovers: The Efficiency Arguments*, 2 J. ECON. PERSP., 69 (1988) (finding that "some takeovers enhance economic efficiency, some degrade it, and the balance of effects, though not fully known, is most likely a close one.").

¹⁵⁹ See, e.g., Suzanne Dawson, Robert Pence and David Stone, *Poison Pill Defensive Measures*, 42 BUS. LAW. 423 (1987) (explaining the role and performance of poison pills).

¹⁶⁰ See, e.g., Lucian A. Bebchuk & Robert J. Jackson, Jr., *Toward a Constitutional Review of the Poison Pill*, 114 COLUM. L. REV. 1549 (2014).

¹⁶¹ See, e.g., Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871 (2002); Bainbridge, *Director Primacy in Takeovers*, *supra* note 61.

¹⁶² See, e.g., Randall A. Heron & Erik Lie, *On the Use of Poison Pills and Defensive Payouts by Takeover Targets*, 79 J. BUS. 1783 (2006) (finding

again, the net effect on control costs will depend on the specific firm.¹⁶³ If honest managers are pursuing a business strategy with hidden value, a pill could reduce principal costs more than it increases agent costs.

A second common takeover defense is the staggered board, on which only one third, rather than the full slate, of incumbent directors stand for election each year.¹⁶⁴ The practical consequence of a staggered board is that a raider must win proxy fights at two successive annual shareholder meetings to obtain control of the company. Proponents argue that staggered boards provide stability and permit greater continuity in a strategic planning.¹⁶⁵ But agency-cost theorists harshly criticize the staggered board as an entrenchment mechanism that, when combined with a pill, makes a firm essentially impervious to hostile raids.¹⁶⁶ Their campaign against staggered board has been effective: over the past decade, Professor Lucian Bebchuk and the Harvard Law School's Shareholder Rights Project have successfully pressured the boards of approximately one-third of all S&P 500 companies to destagger.¹⁶⁷ Before this campaign, a majority of S&P 500 companies had staggered boards; now, most do not.¹⁶⁸

that "poison pills contribute to bid increases and higher bids, yet do not alter the likelihood of takeover").

¹⁶³ See, e.g., Michael Ryngaert, *The Effect of Poison Pill Securities on Shareholder Wealth*, 20 J. FIN. ECON. 377 (1988) (finding that "on average, poison pill defenses have seemingly had only a modest effect on firm valuation.")

¹⁶⁴ See Del. Code. Ann. tit. 8, § 141(d).

¹⁶⁵ See, e.g., Lipton, *supra* note 20.

¹⁶⁶ See, e.g., Lucian A. Bebchuk, John C. Coates & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) (criticizing staggered boards for generating agency costs); Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409 (2005) (finding that "staggered boards are associated with an economically meaningful reduction in firm value").

¹⁶⁷ See Lucian A. Bebchuk, Scott Hirst & June Rhee, *Towards the Declassification of S&P 500 Boards*, 3 HARV. BUS. L. REV. 157 (2013); Steven Davidoff Soloman, *The Case Against Staggered Boards*, N.Y. Times (Mar. 20, 2012), <http://dealbook.nytimes.com/2012/03/20/the-case-against-staggered-boards> (describing this campaign).

¹⁶⁸ See Davidoff, *id.*

Principal-cost theory suggests that staggered boards increase agent costs but reduce principal costs. Due to a lack of information or a misunderstanding of their firm's business model, shareholders will sometimes fail to recognize its hidden value, and thus might tender to a raider at an inadequate price. Fearing such mistakes, boards may eschew complex, long-term business strategies that would ultimately deliver higher shareholder returns. Staggered boards make it harder for shareholders to make such mistakes, freeing boards to pursue multi-year strategies.¹⁶⁹ As with poison pills, some firms will benefit from staggered boards, while others will not.¹⁷⁰

Empirical studies of takeover defenses have produced mixed results.¹⁷¹ While several studies have found that antitakeover devices reduce firm value,¹⁷² others have identified flaws in these studies,¹⁷³ and a third set of studies has found that firms with certain attributes can increase their value by adopting antitakeover

¹⁶⁹ See, e.g., Lipton, *supra* note 124.

¹⁷⁰ See, e.g., Martijn Cremers, Lubomir Litov & Simone Sepe, *Staggered Boards and Long-Term Firm Value, Revisited* (Mar. 14, 2016) (unpublished manuscript), <http://ssrn.com/abstract=2364165> (finding that “firms adopting a staggered board increase in value, while de-staggering is associated with a decrease in value,” and that the “positive association between firm value and staggered boards is driven by firms more engaged in research and where firm-specific stakeholder investments are more important, suggesting that staggered boards may promote long-term value creation by serving as a credible commitment device towards investments in long-term projects and stronger stakeholder relationships.”).

¹⁷¹ See, e.g., Miroslava Straska & H. Gregory Waller, *Antitakeover Provisions and Shareholder Wealth: A Survey of the Literature*, 49 J. FIN. & QUANT. ANAL. 933 (2014) (reviewing forty years of studies and concluding that despite “the considerable amount of time and attention devoted to examining how antitakeover provisions affect shareholders, the net effects of these provisions on shareholder wealth remain uncertain”).

¹⁷² See, e.g., Paul Malatesta & Ralph Walkling, *Poison Pill Securities, Stockholder Wealth, Profitability, and Ownership Structure*, 20 J. FIN. ECON. 347 (1988) (finding that “poison pill defenses reduce stockholder wealth by a statistically significant amount.”).

¹⁷³ John C. Coates IV, *Takeover Defenses In The Shadow Of The Pill: A Critique Of The Scientific Evidence*, 79 TEX. L. REV. 271 (2000); Emiliano Catan & Marcel Kahan, *The Law and Finance of Anti-Takeover Statutes*, 68 STAN. L. REV. (forthcoming, 2016).

devices, as principal-cost theory predicts.¹⁷⁴ The same conflicting results are also seen in studies that seek to link staggered boards to reduced firm value: some studies find that correlation,¹⁷⁵ but others that control for firm-specific characteristics find no such effect.¹⁷⁶

Perhaps the best illustration of the predictive power of principal-cost theory on this point is a pair of studies of a 1990 Massachusetts law that required all public firms incorporated in that state to have staggered boards. An event study by Professor Robert Daines found that the law reduced shareholder wealth.¹⁷⁷ This finding is consistent with agency-cost theory, which holds that staggered boards are *always* value-decreasing; it also is consistent with principal-cost theory, which holds that a mandatory structural element harms firms whose cost-minimizing governance structure does not include that element. However, in a recent study, Daines and two coauthors revisited the Massachusetts firms fifteen years later, and found that those with specific attributes—a high degree of innovation and reliance on R&D—had rebounded in value. The authors concluded that staggered boards can benefit

¹⁷⁴ See, e.g., Miroslava Straska & Gregory Waller, *Do Antitakeover Provisions Harm Shareholders?*, 16 J. CORP. FIN. 487 (2010) (finding that firm value increases in antitakeover indexes for firms with low bargaining power); D. Kadyrzhanova and M. Rhodes-Kropf, *Concentrating on Governance*, 66 J. FIN. 1649 (2011) (finding that firm value increases in delay provisions for firms in concentrated industries, while firm value decreases in nondelay provisions for concentrated industries where the discipline imposed by product market competition on managers is low); Scott Linn & John McConnell, *An Empirical Investigation of the Impact of 'Antitakeover' Amendments on Common Stock Prices*, 11 J. FIN. ECON. 361 (1983) (finding that “antitakeover amendments are proposed by managers who seek to increase the value of the firm and are approved by stockholders who share that objective.”).

¹⁷⁵ See, e.g., Bebchuk & Cohen, *supra* note 166.

¹⁷⁶ See, e.g., Thomas Bates, David Becher & Michael Lemmon, *Board Classification and Managerial Entrenchment: Evidence from The Market for Corporate Control*, 87 J. FIN. ECON. 656 (2008) (finding that “the evidence is inconsistent with the conventional wisdom that board classification is an anti-takeover device that facilitates managerial entrenchment.”).

¹⁷⁷ Robert Daines, *Do Classified Boards Affect Firm Value? Takeover Defenses After The Poison Pill* (unpublished manuscript) (on file with the authors) (finding that “classified boards reduce firm value”).

firms with certain attributes.¹⁷⁸ This result is consistent with principal-cost theory, which predicts that firms will respond to an external legal shock by adjusting other structural features, as well as attributes such as their choice of business strategy.

4. Hedge-Fund Activism — Agency-cost theorists strongly support activist hedge funds,¹⁷⁹ whose business model is to challenge incumbent directors of public companies through publicity campaigns and proxy fights.¹⁸⁰ Such challenges overcome shareholders' rational apathy and institutional investors' rational reticence, increasing the effective power of shareholder voting rights and thus reducing agent costs.¹⁸¹ For example, an activist fund might successfully force a reduction of inefficient capital expenditures by managers engaged in empire-building.¹⁸² Yet activist funds can also generate principal costs, a downside that their academic supporters ignore. Because information asymmetries can prevent shareholders from differentiating good activist campaigns from bad ones, a fund might force managers to slash capital expenditures that are actually efficient.¹⁸³ Ultimately, the impact of activism on control costs—the reduction in agent costs, net of the increase in principal costs—will be specific to the target firm.

Empirical studies of hedge-fund activism have produced mixed results.¹⁸⁴ All studies show that firms experience an initial spike in share price when the market learns that the firms have been targeted. But the long-term impact on share price is unclear: some studies have found that activism improves long-term

¹⁷⁸ Robert Daines, Shelley Xin Li & Charles C.Y. Wang, *Can Staggered Boards Improve Value? Evidence from the Massachusetts Natural Experiment* (on file with authors) (finding that “staggered boards can be beneficial when firms and investors face information asymmetries - when firms are young, innovative, and reliant on R&D”).

¹⁷⁹ See, e.g., Bebchuk et al., *Long-Term*, *supra* note 39.

¹⁸⁰ See Kahan & Rock, *supra* note 37.

¹⁸¹ See Gilson & Gordon, *supra* note 37.

¹⁸² Bebchuk et al., *Long-Term*, *supra* note 39.

¹⁸³ See, John Coffee & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance* (2015) (unpublished manuscript), <http://ssrn.com/abstract=2656325> (giving the pharmaceutical industry's practice of slushing R&D as illustration).

¹⁸⁴ See Coffee and Palia, *id.* (reviewing and analyzing the empirical studies).

performance,¹⁸⁵ but others have found flaws in these studies,¹⁸⁶ and a third set has found that activism ultimately harms its targets,¹⁸⁷ a result that principal-cost theory can explain but agency-cost theory cannot. We further note that all existing studies of activism have considered only its impact on target firms, and thus have not investigated whether the mere risk of being targeted causes managers of other firms to take preventative measures that increase or reduce value.¹⁸⁸ In other words, activist campaigns could generate both positive and negative externalities, but no study investigates them, precluding any conclusion about activism's net impact.

5. Majority Voting — The default rule for Delaware corporations is plurality voting, which permits an uncontested slate of directors to be elected even if holders of a majority of shares express disapproval by withholding their votes.¹⁸⁹ The alternative rule is majority voting, under which directors who do not receive majority support must resign their seats.¹⁹⁰ Majority voting thus provides a cheap substitute for a proxy fight. Because majority voting increases shareholder power, agency-cost theorists view it in a positive light.¹⁹¹ An increase in shareholder power will,

¹⁸⁵ See, e.g., Bebchuk et al, *Long-Term*, *supra* note 39.

¹⁸⁶ See, e.g., Coffee and Palia, *supra* note 183.

¹⁸⁷ See Martijn Cremers, Erasmo Giambona, Simone Sepe & Ye Wang, *Hedge Fund Activism and Long-Term Firm Value* (2015) <http://ssrn.com/abstract=2693231> (finding that “firms targeted by activist hedge funds improve less in value after activist hedge fund campaigns than ex-ante similarly poorly performing control firms that are not subject to hedge fund activism”).

¹⁸⁸ See Coffee & Palia, *supra* note 183.

¹⁸⁹ Del. Code. Ann. tit. 8, § 216 (“In the absence of such specification in the certificate of incorporation or bylaws of the corporation . . . Directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors”); Joseph Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians inside the Gates*, 45 STAN. L. REV. 857, 865-66 (1993) (advocating withholding votes for symbolic “no”).

¹⁹⁰ See, e.g., Stephen Choi, Jill Fisch, Marcel Kahan & Edward Rock, *Does Majority Voting Improve Board Accountability?* 83 U. CHI. L. REV. (forthcoming, 2016) (explaining the different systems of voting).

¹⁹¹ See, e.g., Council of Institutional Investors, *Majority Voting for Directors*, http://www.cii.org/majority_voting_directors (last visited July

however, increase principal costs, and thus may increase overall control costs at many firms. Unsurprisingly, studies of majority voting have produced inconclusive results: while one finds a positive effect,¹⁹² others find no impact on shareholder value.¹⁹³ Principal-cost theory predicts that, once we control for firm-specific characteristics, firms with majority voting will not consistently outperform those without it; therefore, studies that do find a directional result probably lack adequate controls or proper samples, and therefore are unlikely to be confirmed by subsequent studies.

6. Proxy Access. — A proxy fight typically costs the challengers about \$5,000,000.¹⁹⁴ The corporation reimburses the challengers only if they prevail.¹⁹⁵ The result is a classic collective-action problem that discourages proxy challenges: challengers bear more of the expected costs of a proxy fight than the expected benefits. Many commentators have proposed to overcome this disincentive through “proxy access,” which permits shareholders with large, long-term holdings to use the corporation’s proxy materials, and thus the corporations’ funds, to seek votes for their

27, 2015) (“Majority voting ensures that shareowners’ votes count and makes directors more accountable to the shareowners they represent.”).

¹⁹² See Yonca Ertimur, Fabrizio Ferri & David Oesch, *Does the Director Election System Matter?: Evidence from Majority Voting*, 20 REV. ACCT. STUD. 1 (2015) (finding that the adoption of shareholder proposals for majority voting is associated with a positive abnormal stock returns).

¹⁹³ Choi, et al, *supra* note 190 (finding that “directors of companies with majority voting rarely fail to receive majority approval – even more rarely than directors of companies with plurality voting”); William K. Sjoström, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459 (2007) (finding no statistically significant market reaction to a company’s adoption of majority voting); Jay Cai, Jacqueline Garner, and Ralph Walkling, *Paper Tiger? An Empirical Analysis of Majority Voting*, 21 J. CORP. FIN. 119 (2013) (finding that “the adoption of majority voting has little effect on director votes, director turnover, or improving firm performance”).

¹⁹⁴ See Nickolay Gantchev, *The Costs Of Shareholder Activism: Evidence From A Sequential Decision Model*, 107 J. FIN. ECON. 610, 623 (2013). (reporting an average cost of \$5.94M)

¹⁹⁵ See Note, *Contestants in Proxy Fight Entitled to Reimbursement of Expenses from Corporate Treasury*, 56 COLUM. L. REV. 633 (1956).

own partial slates of director candidates.¹⁹⁶ Proxy access reinforces majority voting: when directors must resign for lack of majority support, proxy access enables shareholders, rather than the remaining incumbent directors, to nominate the replacements. In this way, it reduces agent costs, and hence, according to agency-cost theorists, will consistently increase firm value.¹⁹⁷

But proxy access also increases principal costs: although it facilitates the replacement of lazy, incompetent, or disloyal directors, it also increases the risk that shareholders will mistakenly replace good directors (thus generating principal competence costs), or will use greater entrée to board seats to extract private benefits (generating principal conflict costs). Indeed, we have direct evidence of the latter: union pension funds have used proxy access as a bargaining chip in labor negotiations.¹⁹⁸ Whether proxy access will increase¹⁹⁹ or decrease²⁰⁰ overall firm value is thus difficult to predict ex ante, which the empirical literature confirms.²⁰¹

¹⁹⁶ See, e.g., Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003). A typical proxy-access bylaw would allow investors owning 3% percent of a company's stock for three or more years to nominate directors for the company's board of directors.

¹⁹⁷ *Id.*

¹⁹⁸ See John G. Matsuoka et al., *Opportunistic Proposals by Union Shareholders*, USC CLASS Research Paper No. CLASS15-25 (Oct. 8, 2015), at 26, <http://ssrn.com/abstract=2666064> (finding evidence of abuse of shareholder-proposal rule by union shareholders in negotiations).

¹⁹⁹ See, e.g., Bo Becker, Daniel Bergstresser, and Guhan Subramanian, *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable's Challenge*, 56 J. LAW & ECON. 127 (2013); Joanna T. Campbell, T. Colin Campbell, David G. Sirmon, L. Bierman, and Christopher S. Tuggle, *Shareholder Influence over Director Nomination via Proxy Access: Implications for Agency Conflict and Stakeholder Value*, 33 STRATEGIC MGMT. J. 1431 (2012).

²⁰⁰ See, e.g., A. C. Akyol, W.F. Lim & P. Verwijmeren, *Shareholders in the Boardroom: Wealth Effects of the SEC's Proposal to Facilitate Director Nominations*, 47 J. FIN. & QUANT. ANAL., 1029 (2012); D.F. Larcker, G. Ormazabal, and D.J. Taylor, *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431 (2011).

²⁰¹ See, e.g., Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347 (2011) (considering the positive and negative effects of proxy access and concluding that “[n]one ... is likely to be very material, and the net effect is likely to be close to zero”).

7. The G Index — Finally, the most famous paper cited in support of agency-cost theory is a study of a corporate governance index, dubbed the G index, that consists of 24 distinct governance factors which purportedly reduce managerial accountability.²⁰² The paper introduced the study and then regressed it against firm value, finding a strong, negative relationship between a firm's value and its index score.²⁰³ This study has, however, been criticized for methodological flaws and misspecifications.²⁰⁴ In addition, a follow-up study showed that the result in the first was entirely driven by the six factors related to takeover defences.²⁰⁵ And a more recent study has shown that, depending on firm-specific characteristics, three of those six factors correlate negatively with firm value, while the other three correlate positively.²⁰⁶ This trend

²⁰² A firm receives a score of one for each governance clause it has, and thus a firm with a score of G-24 has the ultimate entrenchment structure in this study.

²⁰³ See Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003).

²⁰⁴ See, e.g., Jianxin Daniel Chi, *Understanding the Endogeneity between Firm Value and Shareholder Rights*, 34 FIN. MGMT 65 (2005) (finding that the negative relation between the G index and Tobin's Q runs from G to Q and not vice versa); Kenneth Lehn, Sukesh Patro & Mengxin Zhao, *Governance Indexes and Valuation: Which Causes Which?*, 13 J. CORP. FIN. 907 (2007) (finding that it is unlikely that the G index causes lower valuations); John E. Core, Wayne R. Guay & Tjomme O. Rusticus, *Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations*, 61 J. FIN. 655 (2006) (finding that weak shareholder rights are unlikely to cause lower abnormal stock returns, and suggesting that the difference in abnormal returns between high and low G-index firms can be due to market model misspecification); Shane A. Johnson, Theodore C. Moorman & Sorin Sorescu, *A Reexamination of Corporate Governance and Equity Prices*, 22 REV. FIN. STUD. 4753 (2009) (finding that the asset-pricing model used in Gompers et al. was misspecified); Martijn Cremers, Vinay B. Nair & Kose John, *Takeovers and the Cross-Section of Returns*, 22 REV. FIN. STUD. 1409 (2009) (finding that the market model used in Gompers et al. was misspecified).

²⁰⁵ See Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009).

²⁰⁶ See Martijn Cremers, Saura Masconale & Simone Sepe, *Commitment and Entrenchment in Corporate Governance*, 110 NW. U. L. REV. 727 (2016) (finding that limiting shareholder rights serves a constructive governance

in studies of the G index confirms principal-cost theory's prediction that, as such studies become more refined, fewer structural elements should in fact be found to correlate with firm performance.²⁰⁷

B. Implications for Lawmakers.

Another important difference between agency-cost theory and principal-cost theory is their policy implications. Agency-cost theorists favor mandatory rules that shift control to shareholders:²⁰⁸ they would ban dual-class shares,²⁰⁹ poison pills,²¹⁰ and staggered boards;²¹¹ and would require majority voting²¹² and proxy access.²¹³ But the inescapable tradeoff between principal costs and agent costs cautions against such one-size-fits-all regulations.²¹⁴ It

function as long as the limits are the result of mutual agreement between the board and shareholders).

²⁰⁷ See, e.g., Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise And Peril Of Corporate Governance Indices*, 108 COLUM. L. REV. 1803 (2008) (finding that “there is no consistent relation between governance indices and measures of corporate performance.”); Tatyana Sokolyk, *The Effects Of Antitakeover Provisions On Acquisition Targets*, 17 J. COR. FIN. 612 (2011) (finding that although individual antitakeover provisions (ATP) have significant effects on takeover outcomes, “the G-Index, which does not account for the diverse effects of ATPs, is not significant in predicting the firm's takeover probability or the size of takeover premia.”)

²⁰⁸ See, e.g., Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989); Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

²⁰⁹ See, e.g., Bebchuk, Kraakman & Triantis, *supra* note 4.

²¹⁰ See Bebchuk & Jackson, *supra* note 160.

²¹¹ See, e.g., Bebchuk, Coates & Subramanian, *supra* note 3.

²¹² See, e.g., Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007).

²¹³ See, e.g., Bebchuk, *supra* note 196.

²¹⁴ See, e.g., Sridhar Arcot & Valentina Bruno, *One Size Does Not Fit All, After All: Evidence from Corporate Governance* (Jan. 15, 2007) (unpublished manuscript), <http://ssrn.com/abstract=887947> (finding that “companies that depart from governance best practice because of genuine circumstances outperform all others and cannot be considered badly governed” and arguing that “flexibility in corporate governance regulation plays a crucial role, because companies are not homogenous entities.”).

suggests that lawmakers should permit a range of governance structures, enabling each firm to allocate control rights in the manner that minimizes control costs.

As an illustration, consider the debate over proxy access. Because proxy access reduces agent costs, most scholars who espouse agency-cost theory would make it mandatory.²¹⁵ Their advocacy found early success in 2010 when the SEC announced Rule 14a-11, which would have required proxy access at all public companies.²¹⁶ Before, however, the rule could go into effect, the D.C. Circuit Court of Appeals vacated it on grounds that the SEC had failed to conduct adequate cost-benefit analysis.²¹⁷ Shifting focus, advocates pressed firms to adopt proxy access voluntarily. Their efforts were buttressed by the Delaware legislature's decision to amend the state's general corporations law to permit proxy-access bylaws,²¹⁸ and again by the SEC, which amended Rule 14a-8 (the town-meeting rule) to allow proxy-access proposals.²¹⁹ A tipping point was reached in 2015, when just over half of all proxy-access proposals submitted under Rule 14a-8 passed,²²⁰ and companies such as General Electric adopted proxy access unilaterally, without a shareholder proposal.²²¹

Despite such successes, shareholders are not always receptive to proxy access, and most large companies have not adopted it.²²² Agency-cost theorists blame this continuing resistance on market failure and destructive conflicts of interest among institutional

²¹⁵ See, e.g., Bebchuk & Hirst, *supra* note 2.

²¹⁶ See Facilitating Shareholder Director Nominations (Release Nos. 33-9136, 34-62764, IC-29384; File No. S7-10-09) (to be codified at 17 C.F.R. pts. 200, 232, 240 and 249), <https://www.sec.gov/rules/final/2010/33-9136.pdf>.

²¹⁷ See *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

²¹⁸ Del. Code. Ann. tit. 8, § 112.

²¹⁹ SEC, Final Rule *supra* note 216.

²²⁰ See Steel, *supra* note 85, at 33 n.210.

²²¹ See Ted Mann & Joann S. Lublin, *GE to Allow Proxy Access for Big Investors*, WALL ST. J. (Feb. 11, 2015), <http://www.wsj.com/articles/ge-amends-bylaws-to-allow-proxy-access-for-big-investors-1423698010>.

²²² See 2015 Proxy Season Review, Sullivan & Cromwell LLP 4 (July 20, 2015), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_2015_Proxy_Season_Review.pdf.

investors,²²³ and thus continue to favor mandatory proxy access for all public firms.²²⁴

Principal-cost theory counsels against mandatory proxy access. Because its impact on control costs depends on firm-specific characteristics,²²⁵ proxy access is likely to benefit some firms but harm others. Therefore, lawmakers should respect shareholders' decision at each firm whether or not to adopt the measure. Indeed, the failure of approximately half of the shareholder proxy-access proposals during the 2015 proxy season suggests that, in many firms, shareholders concluded that proxy access would increase principal costs more than it would decrease agent costs.²²⁶ At the same time, the adoption of proxy access by numerous public corporations suggests that there are no persistent market failures or conflicts of interest that prevent investors from choosing the right governance features for their firms.

The debate on proxy access also reveals an important difference between the two theories regarding the setting of default rules. Agency-cost theory, as interpreted by many legal scholars, suggests that default rules should be set to empower shareholders.²²⁷ Because shareholders are dispersed and management is unified, shareholders who wish to opt out of a management-favoring default rule face a high hurdle. The implication is that default rules should be set to empower shareholders, and management should have the burden of persuading shareholders that the default setting is not optimal for their firm.²²⁸ To make its case, management might have to provide

²²³ See, e.g., Joann Lublin, *Investors Gain Greater Clout Over Boards*, <http://www.wsj.com/articles/investors-gain-greater-clout-over-boards-1452470402>

²²⁴ See, e.g., Bebchuk & Hirst, *supra* note 2.

²²⁵ See section III.A.6, *supra*.

²²⁶ See Steel, *supra* note 85, at 33 n.210.

²²⁷ See Lucian Ayre Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489 (2002) [hereinafter Bebchuk & Hamdani, *Optimal Defaults*]; Lucian Ayre Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1410–13 (1989).

²²⁸ See Bebchuk & Hamdani, *Optimal Defaults*, *id.*

shareholders with inside information, making it more likely that the parties will jointly choose the optimal rule.²²⁹

Principal-cost theory suggests a different prescription. If a default rule assigns control to shareholders, management might fail to convince shareholders to opt out if shareholders, hampered by collective-action problems, mistakenly resist the change. Such a result would be an example of principal competence costs.²³⁰ Indeed, even when shareholders *do* decide correctly, they will incur transaction and information costs in deciding, another type of principal cost that agency-cost theory neglects. The prospect of such costs could stop management from attempting to opt out if it decides that the costs of persuading shareholders do not exceed the benefits. As a result, many inefficient rules could be left in place.²³¹ This hazard seems large given the influence wielded by proxy advisors such as Institutional Shareholder Services, which typically supports shareholder-empowering rules without investigating their likely impact on any particular firm.²³² Moreover, the same difficulties that managers face in conveying information to avoid shareholder short-termism will hamper attempts to persuade shareholders to change inefficient default rules.

As for the concern that the collective-action problem will impede shareholders from initiating change, the successful

²²⁹ Cf. Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1397–400 (1992); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989).

²³⁰ To see this, one need only to read the recent policy of ISS regarding new public companies, according to which ISS will generally recommend “vote against” or “withhold” for directors of a company that, prior to or in connection with its IPO, adopted bylaw or charter provisions that ISS considers adverse to shareholders’ rights. See Joseph A. Hall, *The Impact of ISS’ New Policy on IPO Company Director Elections*, at <https://corpgov.law.harvard.edu/2016/08/10/the-impact-of-iss-new-policy-on-ipo-company-director-elections/>.

²³¹ This explanation was also offered by Daines et al, *supra* note 178.

²³² See, e.g., Robert Daines, Ian Gow & David Larcker, *Rating the Ratings: How Good are Commercial Governance Ratings?*, 98 J. FIN. ECON. 439 (2010) (finding that commercially available corporate governance rankings do not provide useful information for shareholders).

campaigns by shareholder-rights advocates to destagger boards,²³³ shift to majority voting,²³⁴ and implement proxy access,²³⁵ suggest that it is unfounded. Even if collective-action problems were once formidable enough to militate for default rules that empower shareholders, the concern seems no longer justified given the prevalence of institutional ownership and shareholder activism today.²³⁶

In short, lawmakers should not mandate changes in the allocation of control rights between investors and managers. Instead, they should adopt measures that enable these parties to craft firm-specific solutions to the many nuances of the perennial principal-agent problem.²³⁷ In particular, lawmakers should transform any rule that dictates the allocation of control rights into a default rule,²³⁸ unless there is a specific market failure.²³⁹ Additionally, when choosing default settings for new firms, lawmakers should not simply pick the setting that empowers shareholders. Rather, they should adopt a majoritarian default, setting the rule that would, at the majority of firms,²⁴⁰ minimize total control costs. For firms that have already crafted their governance structures, lawmakers should respect the status quo. Certainly, they should never impose a new mandatory rule: as illustrated by Massachusetts's experience with compulsory staggered boards, most firms have already adjusted their

²³³ See note 167, *supra*, and accompanying text.

²³⁴ See Choi *et al.*, *supra* note 190.

²³⁵ See note 220 *supra*, and accompanying text.

²³⁶ See Gilson & Gordon, *supra* note 37.

²³⁷ The claim that corporate law should be governed by default rules is a central idea of the contractarian approach to corporate law. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); Henry Hansmann & Reinier Kraakman, *The End of History in Corporate Law*, 89 *GEO L.J.* 439 (2001).

²³⁸ See, e.g., Stephen M Bainbridge, *Preserving Director Primacy by Managing Shareholder Interventions* (August 27, 2013), Research Handbook on Shareholder Power and Activism (forthcoming), at <http://ssrn.com/abstract=2298415> (suggesting to allow corporations to opt out of the SEC's mandatory shareholder proposal rule).

²³⁹ See, e.g., Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 *COLUM. L. REV.* 1599 (1989).

²⁴⁰ See, e.g., Easterbrook & Fischel, *supra* note 237.

governance structures, capital structures, and business strategies to minimize the sum of principal costs and agent costs within the existing legal environment.

V. Conclusion

This Article has introduced the principal-cost theory of corporate law and governance. The theory argues that a business firm's optimal governance structure minimizes the sum of principal costs and agent costs. Principal costs arise when investors, due to honest mistakes or self-seeking motives, exercise control in a manner that reduces a firm's value. Agent costs arise when managers do the same. There is an unavoidable tradeoff between principal costs and agent costs: any reallocation of control rights in a firm necessarily decreases one type of cost but increases the other. The division of control that minimizes the sum of principal costs and agent costs is firm-specific, based on factors such as industry, business strategy, and the personal characteristics of the investors and managers.

Principal-cost theory explains features of business firms that agency-cost theory, the prevailing paradigm in the study of corporate law, cannot. Agency-cost theory posits that, at any given level of production, a firm's optimal governance structure minimizes agent conflict costs: the direct and indirect costs of self-seeking conduct by managers. This theory cannot explain why, even in wholly-owned firms, the investor often delegates control to a manager. Nor can it explain why shareholders invest in firms whose governance structures restrict, to varying degrees, the shareholders' power to replace managers and otherwise hold them accountable. Principal-cost theory can explain both practices: they reflect the goal of reducing principal costs. Agency-cost theory also cannot explain the spectrum of governance structures that firms adopt, ranging from structures that give managers autonomy (such as the dual-class share structure), to those that empower shareholders to hold managers accountable (such as the dispersed ownership structure without a staggered board). Principal-cost theory, by contrast, explains that the spectrum reflects the firm-specific nature of the principal-cost/agent-cost tradeoff.

Principal-cost theory also offers different empirical predictions and policy prescriptions. Agency-cost theory implies that corporate

2016]

Principal Costs

71

governance features which disempower shareholders, such as staggered boards and dual-class shares, will correlate negatively with firm value, and thus should be banned. Principal-cost theory predicts that, once a study properly controls for firm-specific characteristics, no such correlations will be found; lawmakers therefore should avoid one-size-fits-all governance rules. This Article has shown that the trend in empirical findings supports principal-cost theory, corroborating the wisdom of its policy prescriptions. Because principal-cost theory reframes most of the key debates in corporate governance, the full extent of its predictive and prescriptive implications is a promising subject of future scholarship.