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PRINCIPAL COSTS: A NEW THEORY FOR CORPORATE LAW AND GOVERNANCE[1]

CUSTOS DE CONTROLADOR: UMA NOVA TEORIA PARA O DIREITO SOCIETÁRIO E A GOVERNANÇA CORPORATIVA

Zohar Goshen
Richard Squire

Abstract: The problem of managerial agency costs dominates debates in corporate law. Many leading scholars advocate reforms that would reduce agency costs by forcing firms to allocate more control to shareholders. Such proposals disregard the costs that shareholders avoid by delegating control to managers and voluntarily restricting their own control rights. This Essay introduces *principal-cost theory*, which posits 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. Both principal costs and agent costs can arise from honest mistakes (which generate *competence costs*) and from disloyal conduct (which generate *conflict costs*). Because the expected costs of competence and conflict are firm-specific, the optimal division of control is firm-specific as well. Thus, firms rationally select from a range of governance structures that empower shareholders to varying degrees. The empirical predictions produced by principal-cost theory are more accurate than those produced by any theory focused solely on agency costs. Principal-cost theory also suggests different policy prescriptions. Rather than banning some governance features and mandating others, lawmakers should permit each firm to tailor its governance structure based on its firm-specific tradeoff between principal costs and agent costs.

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Keywords: Corporate Law. Corporate Governance. Control. Principal-costs Theory. Principal Costs. Agency Costs.

Resumo: O problema dos custos gerenciais de agência domina os debates no direito societário. Muitos dos principais estudiosos defendem reformas que reduziriam os custos de agência ao forçar sociedades a alocar maior parcela de controle aos acionistas. Essas propostas desconsideram os custos que os acionistas evitam ao delegarem o controle a administradores e ao voluntariamente restringirem seu próprio direito de controle. Esse artigo apresenta a *teoria dos custos de controlador*, a qual postula que a estrutura de governança ideal de cada sociedade minimiza a soma de *custos de controlador*, produzido quando investidores exercem o controle, e de *custos de agência*, produzido quando administradores exercem o controle. Ambos os custos de controlador e de agência podem resultar de erros honestos (que geram *custos de competência*) e de condutas desleais (que geram *custos de conflitos*). Como os esperados custos de competência e de conflito são específicos a cada sociedade, a divisão ideal de controle também é específica a cada sociedade. Assim, sociedades racionalmente selecionam de uma variedade de estruturas de governança que capacitam os acionistas em diferentes graus. As projeções empíricas produzidas pela teoria dos custos de controlador são mais precisas do que aquelas produzidas por qualquer outra teoria focada unicamente nos custos de agência. A teoria dos custos de controlador também propõe diferentes prescrições de normas. Ao invés de proibir algumas características de governança e impor outras, os legisladores devem permitir que cada sociedade possa desenhar sua própria estrutura de governança com base em seu específico equilíbrio entre custos de controlador e custos de agência.

Palavras-chave: Direito Societário. Governança Corporativa. Controle. Teoria do Custos de Controlador. Custos de Controlador. Custos de Agência.

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Introduction.

For the last forty years, the problem of agency costs has dominated the study of corporate law and governance.[2] Agency costs re-

2 For the seminal work on agency costs in business firms, see Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976).

sult from the separation of control and ownership that occurs when managers run a firm but must share its profits with equityholders.[3] Such managers face incentives to expend less effort and consume more perquisites than they would if they were the firm's sole owners.[4] By shirking their duties and diverting value, managers generate agency costs, which reduce their firm's value.[5] Many scholars – we refer to them as *agency-cost essentialists* – treat the reduction of agency costs as the essential function of corporate law and of related fields such as securities regulation. To reduce agency costs, the essentialists would mandate corporate-governance arrangements, such as proxy access, that allocate more control rights to shareholders.[6] And they would ban arrangements that disempower shareholders, such as staggered boards[7] and dual-class shares.[8] To the essentialists, the reduction of agency costs is an unalloyed good toward which all aspects of corporate law and governance should be directed.[9]

Drawing upon a seminal paper by Professors Michael Jensen and William Meckling,[10] agency-cost essentialists assume that firms

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3 Id. at 309.

4 Id. at 309.

5 Id. at 313.

6 See, e.g., Lucian A. Bebchuk & Scott Hirst, Private Ordering and the Proxy Access Debate, 65 Bus. Law. 329, 335–36 (2010) (advocating a proxy access default rule).

7 See, e.g., Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy, 54 Stan. L. Rev. 887, 919 (2002) [hereinafter Bebchuk et al., Force of Staggered Boards] (noting that an effective staggered board "should provide incumbents virtually complete protection from hostile bids, with all of the potential drawbacks in terms of managerial agency costs that are associated with such insulation").

8 See, e.g., Lucian Arye Bebchuk, Reinier Kraakman & George G. 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 295, 310–11 (Randall K. Morck ed., 2000) [hereinafter Bebchuk et al., Stock Pyramids] (finding high agency costs in firms with controlling shareholders, including those with dual-class shares).

9 See, e.g., Lucian Arye Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 833 (2005) [hereinafter Bebchuk, Shareholder Power].

10 See Jensen & Meckling, supra note 2.

delegate control to managers, thereby separating control from ownership, solely to facilitate the aggregation of capital from multiple investors.[11] Yet many wholly owned firms also delegate control to managers, thereby incurring agency costs that, under agency-cost essentialism, serve no positive function.[12] The essentialists also have difficulty explaining why corporations often choose to go public with staggered boards, whose members are subject to discretionary removal by shareholders only once every three years rather than annually,[13] or with a dual-class share structure, which denies outside shareholders the right to replace directors at all.[14] If capital aggregation were the sole benefit of delegating control to managers, firms that tied investors' hands in such ways would consistently generate lower financial returns than those that give more power to shareholders. Yet careful empirical studies find no consistent relationship between the degree of shareholder empowerment and overall financial performance.[15] Such studies confirm the intuition that investors also generate costs when they exercise control and that firms must weigh those costs against agency costs when selecting a governance structure. By ignoring that tradeoff, agency-cost essentialism produces inaccurate empirical predictions and unwise policy prescriptions.

To correct the shortcomings of agency-cost essentialism, we offer a theory of corporate governance that we term *principal-cost*

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11 Aggregating capital from multiple investors enables a firm to achieve economies of scale, and it enables investors to diversify risk. Jensen & Meckling, supra note 2, at 313 & n.15. Economies of scale are efficiencies that a firm achieves by increasing output; they typically manifest in a decline in average cost per unit of production as the number of units produced rises. Richard A. Posner, Economic Analysis of Law 413 (8th ed. 2011).

12 Daniel Ames, The Relation Between Private Ownership of Equity and Executive Compensation, 13 J. Bus. Inquiry 81, 84 (2014) (detailing the practice whereby wholly owned corporations employ professional managers).

13 See, e.g., Del. Code Ann. tit. 8, § 141(d) (2016) (allowing corporations to adopt staggered boards in their certificates of incorporation).

14 See Zohar Goshen & Assaf Hamdani, Corporate Control and Idiosyncratic Vision, 125 Yale L.J. 560, 590–91 (2016).

15 For a description of the studies, see infra section IV.A.

theory. The theory states that each firm's optimal governance structure minimizes total *control costs*, which are the sum of *principal costs* and *agent costs*.[16] Principal costs occur when investors exercise control, and agent costs occur when managers exercise control. Both types of cost can be subdivided into *competence costs*, which arise from honest mistakes attributable to a lack of expertise, information, or talent, and *conflict costs*, which arise from the skewed incentives produced by the separation of ownership and control. When investors exercise control, they make mistakes due to a lack of expertise, information, or talent, thereby generating principal competence costs. To avoid such costs, they delegate control to managers whom they expect will run the firm more competently. But delegation separates ownership from control, leading to agent conflict costs, and also to principal conflict costs to the extent that principals retain the power to hold managers accountable. Finally, managers themselves can make honest mistakes, generating agent competence costs.

Principal costs and agent costs are substitutes for each other: Any reallocation of control rights between investors and managers decreases one type of cost but increases the other.[17] The rate of substitution is firmspecific, based on factors such as the firm's business strategy, its industry, and the personal characteristics of its investors and managers. 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 law's proper role is to allow firms to select from a wide range of governance structures, rather than to mandate some structures and ban others.

Agency-cost essentialists focus on one of the four categories of control costs we have identified: agent conflict costs.[18] They down-

16 For the full analysis of these concepts, see infra Part II.

17 See infra section III.A.

18 See, e.g., John Armour, Henry Hansmann & Reinier Kraakman, What Is Corporate Law?, in

play agent competence costs and, more importantly, disregard both types of principal costs.[19] Yet principal costs are more fundamental than agent costs, as the goal of reducing them is the reason that investors delegate control to managers, generating the conflict costs that preoccupy agency-cost essentialists. We term our thesis in this Essay principal-cost theory because principal costs are the logical starting point in analyzing problems of firm governance, including the question of why firms adopt such a wide variety of governance structures.

A firm that seeks to maximize total returns will weigh principal costs against agent costs when deciding how to divide control between managers and investors. When a firm has multiple investors, principal costs arise primarily from conflicting interests (which generate principal conflict costs) and the duplicative efforts and coordination problems entailed by joint decisionmaking (which generate principal competence costs).[20] 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 expertise, information, or talent.[21] Indeed, the goal of reducing principal competence costs explains why even wholly owned firms often delegate control to managers.

The firm-specific nature of the tradeoff between principal costs and agent costs is the reason that 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

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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 ...").

19 For an example, see infra section I.B (discussing the second limiting assumption of Jensen and Meckling).

20 See Henry Hansmann, Ownership of the Firm, 4 J.L. Econ. & Org. 267, 277–80 (1988) (analyzing costs of collective decisionmaking).

21 See infra section II.A.1.

is the dual-class share structure, which gives controlling owner-managers complete and incontestable control.[22] Firms that adopt a dual-class share structure minimize potential principal costs but run the risk of high agent costs. At the opposite end of the spectrum – rarely seen except in sole proprietorships and small partnerships – are firms whose equity investors retain full control over the selection and development of business strategy.[23] Such firms minimize potential agent costs but run the risk of high principal costs. Toward the middle of the spectrum is the most common governance structure in American public corporations: dispersed share ownership.[24] Managers of firms with that structure exercise a large degree of control, which can generate significant agent costs. But shareholders can contest control through a hostile tender offer or activism, the prospect of which keeps agent costs in check.[25] Because, however, hostile raiders and activist hedge funds sometimes mistakenly target firms whose managers are in fact effective,[26] this ownership structure can also generate significant principal costs.

To be sure, we are not the first commentators to observe that shareholders (as opposed to managers) generate costs when exercis-

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22 See infra section III.D.1.

23 See infra section III.D.2.

24 The concentrated-ownership structure is usually contrasted with the dispersed-ownership structure, the prevailing structure among public firms in the United States and the United Kingdom. See Ronald C. Anderson & David M. Reeb, Founding-Family Ownership and Firm Performance: Evidence from the S&P 500, 58 J. Fin. 1301, 1302 (2003) (stating that roughly 35% 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 A History of Corporate Governance Around the World: Family Business Groups to Professional Managers 613, 613–14 (Randall K. Morck ed., 2007) (contrasting the prevalence of dispersed-share ownership in the United States with block-share ownership in other countries). But see Clifford G. Holderness, The Myth of Diffuse Ownership in the United States, 22 Rev. Fin. Stud. 1377, 1378, 1382 tbl.1 (2009) (presenting evidence casting doubt on the prevailing view that the ownership of most American public firms is widely dispersed).

25 See infra notes 207–213 and accompanying text.

26 See infra note 214 and accompanying text.

ing control. Previous scholarship had identified particular sources of what we call principal costs, such as short-termism, shareholder conflicts of interest, and collective-action problems.[27] Other commentators have not, however, identified the complete set of principal costs that we describe here (including both competence costs and conflict costs), nor have they conceptualized principal costs as a general category that is logically prior to agent costs.[28] We also are the first commentators to describe how the unavoidable tradeoff between principal costs and agent costs determines each firm's optimal governance structure.[29]

These contributions make salient two aspects of the corporate governance problem that scholars who fixate on agency costs 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.

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27 See Leo E. Strine Jr., Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance, 33 J. Corp. L. 1, 6 (2007) ("As much as corporate law scholars fetishize the agency costs that flow from the separation of ownership and control in operating companies, they have been amazingly quiet about the 'separation of ownership from ownership.'"); see also Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. Rev. 811, 821–22, 826–27 (1992) (discussing collective-action problems and the conflicts of interest of institutional investors); Lynne L. Dallas, Short-Termism, the Financial Crisis, and Corporate Governance, 37 J. Corp. L. 265, 267–73 (2012) (analyzing the short-termism problem); Jeffrey N. Gordon, Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law, 60 U. Cin. L. Rev. 347, 359–63 (1991) (describing shareholder "cycling" and its potential destructive effects); Edward B. Rock, Controlling the Dark Side of Relational Investing, 15 Cardozo L. Rev. 987, 1000–04, 1003 n.72 (1994) (describing the conflict of interests between relational investors, shareholders, and managers); Roberta Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, 93 Colum. L. Rev. 795, 799–839 (1993) (discussing the conflicts of public pension funds); infra notes 113–120 and accompanying text (detailing previous scholarship on the principal-cost theory).

28 Cf. infra section II.A.

29 See infra sections III.C.–D.

One test of a theory is the accuracy of its predictions. Principal-cost theory makes different predictions than agency-cost essentialism about the relationship between firm value and particular governance structures. Essentialism suggests that firms that adopt shareholder-disempowering governance features, such as staggered boards and dual-class shares, will consistently underperform those that do not.[30] Principal-cost theory, by contrast, states 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 and considers a sufficiently long period of time will find no correlation between particular structural features and firm value.[31] As we show in this Essay, principal-cost theory does in fact explain the results of most empirical studies better than agency-cost essentialism does.[32]

A second test of a theory is the wisdom of its policy prescriptions. Agency-cost essentialists advocate shifting more control to shareholders,[33] while a smaller group of scholars – sometimes referred to as the director-supremacy school[34] – seeks to insulate corporate managers from control contests.[35] Principal-cost theory suggests that

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30 See infra notes 215–217 and accompanying text.

31 Several economists have critiqued the empirical work by claiming that corporate governance is endogenous and therefore that cross-sectional variation in governance structure should not correlate with performance. See, e.g., Harold Demsetz & Kenneth Lehn, The Structure of Corporate Ownership: Causes and Consequences, 93 J. Pol. Econ. 1155, 1173–74 (1985). Principal-cost theory explains why corporate governance is endogenous.

32 See infra section IV.A.

33 See, e.g., Bebchuk, Shareholder Power, supra note 9, at 865–70 (discussing the benefits of increasing shareholder power and advocating a regime permitting shareholders to "set the rules").

34 See, e.g., Stephen M. Bainbridge, Director Primacy and Shareholder Disempowerment, 119 Harv. L. Rev. 1735, 1744–51 (2006) [hereinafter Bainbridge, Shareholder Disempowerment] (arguing that preservation of managerial discretion should remain the default rule).

35 See, e.g., id. at 1747–49 (surveying corporate law rules that protect managers and arguing that shareholder voting rights should do the same); Martin Lipton & Steven A. Rosenblum, A

both policy prescriptions are unwise, as both would treat all firms the same.[36] 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, lawmakers 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.

Part I of this Essay describes agency-cost essentialism and identifies its shortcomings, especially its inability to explain common features of the governance structures that business firms adopt. Part II introduces and defines the two types of control costs: competence costs and conflict costs. Part III presents principal-cost theory and shows why it explains what agency-cost essentialism cannot. Part III also describes how the governance structures that firms select can be arranged along a spectrum that depicts each structure's distinct tradeoff between principal costs and agent costs. Finally, Part IV describes how principal-cost theory generates empirical predictions and policy prescriptions superior to those produced by agency-cost essentialism.

I. The Limits of Agency Costs.

The subject of most corporate law scholarship is the conflict of interests between managers (broadly defined to include directors) and shareholders.[37] Scholars almost invariably conceptualize this con-

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New System of Governance: The Quinquennial Election of Directors, 58 U. Chi. L. Rev. 187, 205–13 (1991) (arguing that the divergent interests of stockholders and corporations necessitate that management be allowed to defend against hostile takeovers). Implicitly, members of the director-supremacy school believe that principal costs are a relatively large problem, although they do not identify the full set of principal costs we describe, nor do they conceptualize principal costs as trading off against agent costs in the choice of a firm's governance structure.

36 See infra notes 38–40 and accompanying text.

37 See John Armour, Henry Hansmann & Reiner Kraakman, Agency Problems and Legal Strate-

flict in terms of agency costs: the economic losses resulting from managers' natural incentive to advance their personal interests even when those interests conflict with the goal of maximizing their firm's value.[38] Agency-cost essentialists – who believe that the reduction of agency costs is the essential role of corporate law and of related fields such as securities regulation – consistently evaluate policy recommendations solely in terms of their capacity to decrease agency costs.[39] And the essentialists condemn governance arrangements such as concentrated ownership and dual-class shares, which restrict shareholders' ability to hold managers accountable.[40] Yet investors also generate costs when they exercise control or hold managers accountable. Because they disregard such costs, agency-cost essentialists have difficulty explaining common features of the governance structures that most firms adopt.

I.A. The Jensen-Meckling Model and Its Extensions.

Although keen observers have been commenting on the problem of agency costs since antiquity,[41] the most influential modern analysis of agency costs in business firms is Jensen and Meckling's 1976 article, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*.[42] The article employs a simple model of a

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gies, in The Anatomy of Corporate Law, supra note 18, at 35, 35–37 (introducing owner–management conflict as one of three "generic agency problems" that arise in corporate law).

38 See infra notes 131–137 and accompanying text.

39 See, e.g., infra section IV.B.

40 See, e.g., Bebchuk et al., Stock Pyramids, supra note 8, at 296 (noting that when controlling shareholders have limited cash-flow rights, agency costs can be "an order of magnitude larger" than when the controllers hold a majority of cash-flow rights).

41 See John 10:12–13 (New International Version) ("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.").

42 Jensen & Meckling, supra note 2.

firm owned jointly by an investor and a manager.[43] The manager runs the firm while the investor provides capital that, in combination with capital contributed by the manager, enables the firm to achieve economies of scale.[44] But the use of the investor's capital has a downside. 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).[45] This separation creates incentives for the manager to engage in self-seeking behavior that reduces the firm's value.[46] He no longer has incentive to work as hard, as the sharing of cash flows with the investor reduces his marginal returns from working relative to his marginal returns from leisure.[47] His reduced diligence may, in turn, lead him to make mistakes that a better-motivated manager would avoid. The sharing of cash flows also increases the manager's incentive to divert the firm's resources to himself in the form of perquisites[48] because he bears only part of the cost of doing so.

Jensen and Meckling used their simple model of a business firm to illustrate the unavoidable tradeoff between economies of scale and agency costs. Economies of scale and agency costs both increase as the firm's manager sells more of the 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.[49] In this way, the Jensen-Meckling model

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43 Id. at 312–14.

44 See id. at 312.

45 Id. at 312–13.

46 Id.

47 Id.

48 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.

49 Id. at 319–26 (exploring the relationship between acceptance of outside financing to increase firm size and resulting agency costs).

shows how the tradeoff between scale economies and agency costs determines the size of a business firm.

A second important contribution of the Jensen-Meckling article is its analysis of the various components of agency costs.[50] Such costs do not consist solely of the direct costs of managerial self-seeking behavior. They also include monitoring costs, which result from efforts by investors to deter managers from shirking and diverting.[51] And they further include bonding costs, which result from efforts by managers to reassure investors that, despite the separation of ownership and control, the managers will work diligently and scrupulously.[52] Managers rationally incur bonding costs because investors who trust them will charge them less for the use of their capital. Thus, as defined by Jensen and Meckling, agency costs have three components: bonding costs, monitoring costs, and the direct costs of agent misconduct that bonding and monitoring do not prevent.[53]

The Jensen-Meckling model has been extraordinarily influential.[54] Delaware courts have used it to frame their analyses of managerial fiduciary duties.[55] Among scholars of corporate law, agency costs are the focus of debates over controversial topics such as executive compensation,[56] hostile takeovers,[57] class actions and derivative

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50 Id. at 308–10.

51 Id. at 308 n.9 (noting that monitoring costs result from "efforts on the part of the principal to 'control' the behavior of the agent").

52 Id. at 308.

53 Id. Jensen and Meckling called these direct costs "residual loss." Id. 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.

54 A Westlaw search of the term "agency costs" yields over 7,000 results. Westlaw, http://westlaw.com/ (search "'agency costs'"; then follow "Secondary Sources" hyperlink) (last visited Jan. 28, 2017).

55 See, e.g., Bird v. Lida, Inc., 681 A.2d 399, 402–03 (Del. Ch. 1996) (citing Jensen and Meckling for the proposition that "imperfect alignment of incentives will inevitably lead to excess costs associated with centralized management").

suits,[58] director self-dealing,[59] the role of institutional investors,[60] the role of activist investors,[61] and shareholder rights to amend corporate

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56 See, e.g., Lucian Ayre Bebchuk & Jesse Fried, Executive Compensation as an Agency Problem, 17 J. Econ. Persp. 71, 71–72 (2003) (referencing the Jensen-Meckling model and noting that "[a]ny discussion of executive compensation must proceed against the background of the fundamental agency problem afflicting management decisionmaking"); Robert J. Jackson, Jr., Private Equity and Executive Compensation, 60 UCLA L. Rev. 638, 646 (2013) (citing Jensen and Meckling to support the suggestion that tying executive compensation to firm performance may reduce agency costs by better motivating executives to maximize shareholder value).

57 See, e.g., Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161, 1169 (1981) [hereinafter Easterbrook & Fischel, The Proper Role] (emphasizing the 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) [hereinafter Gilson, Structural Approach] (arguing that defensive tactics are inappropriate because of the importance of a "market for corporate control" as a means of reducing agency costs).

58 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, 19–26 (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, 2064–66 (1995) (analyzing agency-cost issues and the misalignment of incentives between plaintiffs' attorneys and plaintiff classes in securities class actions).

59 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) (discussing agency costs that exist when a corporate-governance system balances management discretion and safeguards against abuse).

60 See, e.g., Black, supra note 27, at 887 ("Procedural reform can facilitate shareholder action, but oversight will occur only if the costs of monitoring are less than the benefits from reducing the agency costs that flow from the separation of ownership and control in our large companies."); John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277, 1283–84 (1991) ("Not only do the same problems of agency cost arise at the institutional investor level, but there are persuasive reasons for believing that some institutional investors are less accountable to their 'owners' than are corporate managements to their shareholders.").

61 See, e.g., Ronald J. Gilson & Jeffrey N. Gordon, The Agency Costs of Agency Capitalism:

bylaws and charters.[62] Inspired by Jensen and Meckling, many scholars assert that corporate law should be reformed to give more power to shareholders. For example, such scholars condemn corporate-governance structures that insulate incumbent managers against hostile takeovers and activist hedge funds.[63] And they apply similar reasoning to the conflict between controlling shareholders and minority shareholders, focusing on the potential for controllers to oppress the minority.[64]

I.B. The Blind Spots of Agency-Cost Essentialism.

By necessity, models make simplifying assumptions that limit

Activist Investors and the Revaluation of Governance Rights, 113 Colum. L. Rev. 863, 870–71 (2013) (referencing the Jensen-Meckling model to contextualize an analysis of agency costs that arise with activist investors); Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1048 (2007) [hereinafter Kahan & Rock, Hedge Funds] (noting that agency costs might limit mutual funds' "ability to act as effective monitors"); Mark J. Roe, Corporate Short-Termism—In the Boardroom and in the Courtroom, 68 Bus. Law. 977, 1005 (2013) (referencing short-term distortions that are internal to corporations as the result of the manager–investor dichotomy).

62 See, e.g., Bebchuk, Shareholder Power, supra note 9, at 903–06 (referencing Jensen and Meckling for the proposition that "high leverage produces its own inefficiency distortions" and citing "shareholder power to make distribution decisions" as a possible solution).

63 See, e.g., Lucian A. Bebchuk, Alon Brav & Wei Jiang, The Long-Term Effects of Hedge Fund Activism, 115 Colum. L. Rev. 1085, 1136 n. 99 (2015) [hereinafter Bebchuk et al., Long-Term] (noting scholarly criticism of hedge fund activism); Lucian A. Bebchuk, The Myth that Insulating Boards Serves Long-Term Value, 113 Colum. L. Rev. 1637, 1686–87 (2013) [hereinafter Bebchuk, Insulating Boards] (rejecting arguments for board insulation and claiming such isolation produces costs that exceed benefits); Easterbrook & Fischel, The Proper Role, supra note 57, at 1198–99 (suggesting that courts should not freely defer to managers who resist tender offers); Gilson, Structural Approach, supra note 57, at 845–46 ("[T]he tender offer is crucial because no other displacement mechanism is available without management cooperation.").

64 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, 165 U. Pa. L. Rev. (forthcoming May 2017) (manuscript at 63–64), http://papers.ssrn.com/abstract=2741738 (on file with the Columbia Law Review).

their explanatory reach. The Jensen-Meckling model is no exception. However, in deriving policy prescriptions from it, many scholars have ignored those limitations. As a result, they effectively assume that, at any given scale of production, the only relevant governance goal is to minimize agency costs.[65] While this is true in the Jensen-Meckling model, it is not true in real business firms.

One of the Jensen-Meckling model's simplifying assumptions is that the manager possesses all *discretionary control rights* – by which we mean rights to select and implement the firm's business strategy. Not only does the investor lack formal power to select the firm's strategy, but he also cannot influence it by, for example, threatening to replace the manager for pursuing a plan the investor thinks unwise.[66] The investor's only control rights in the model are *duty-enforcement rights*, by which we mean rights to enforce contractual obligations, and judge-made fiduciary duties, designed to deter self-seeking conduct by the manager.[67] It is the exercise of these rights that generates what Jensen and Meckling called monitoring costs.[68] 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 in the model is that no one makes honest mistakes. While the manager does not always advance the interests of the investor, he serves his own interests flawlessly. He

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65 See, e.g., Bebchuk et al., Stock Pyramids, supra note 8, at 295–96, 314 (examining agency-controlling-minority-structure firms and stating "the case for regulation is made if the agency costs of these structures are large and there is strong evidence of a divergence between private and social benefits in their creation").

66 See Jensen & Meckling, supra note 2, at 313–14 (assuming investors lack voting rights).

67 For further discussion of such discretionary control rights and duty-enforcement rights, see infra section III.B.

68 See Jensen & Meckling, supra note 2, at 313; see also id. at 308 n. 9 (noting that monitoring "includes efforts on the part of the principal to 'control' the behavior of the agent through budget restrictions, compensation policies, operating rules etc.").

selects the business strategy most profitable to him and execute it without error. Similarly, the investor always exercises his duty-enforcement rights in the manner that minimizes agency costs. In other words, he engages only in *efficient* monitoring. The model thus ignores competence costs. 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 conduct by the manager. In real firms, managers generate costs not just by deliberately shirking and diverting but also by making unwise decisions attributable to a lack of expertise, information, or innate ability.[69] And investors make such mistakes as well, including by hiring the wrong managers. But such mistakes are not part of the Jensen-Meckling model.

In combination, these two limiting assumptions of the Jensen-Meckling model exclude principal costs. This exclusion is reasonable given Jensen and Meckling's objective, which was to show how agent conflict costs limit a firm's scale of production. Their model achieves this objective elegantly. Moreover, the authors were careful to acknowledge their model's limitations.[70] Yet many scholars have tried to apply the model to a different question, namely the optimal division of control between investors and managers at any given level of production. And these scholars have concluded, in effect, that minimizing agent conflict costs is the only relevant objective when dividing control rights. Put another way, these agency-cost essentialists effectively assume that the governance structure that minimizes agent conflict costs also maximizes firm value, thereby ignoring the impact of

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69 See infra section II.A.2 (discussing agent competence costs).

70 See Jensen & Meckling, supra note 2, at 351–52 (noting the assumption "that all outside equity is nonvoting" and that a future complete analysis "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 stockholders in implementing policy changes"); id. at 356 (stating the theory "is applicable to a wide range of corporations" even though it is "in an incomplete state" and noting "[o]ne of the most serious limitation[s] of the analysis is ... its application to the very large modern Corporation whose managers own little or no equity").

governance structure on principal costs. As a result, they consistently advocate mandatory structures that would increase the power of shareholders to hold managers accountable.[71]

By disregarding principal costs, agency-cost essentialists have difficulty explaining why, even in a firm whose capital is provided by a single investor, the investor often hires a manager to run the firm. Since the investor provides all funding, the manager is not needed to achieve economies of scale, which is the reason for the separation of ownership and control in the Jensen-Meckling model.[72] Recognizing this blind spot, some scholars have explained their models with a story along the lines that the entrepreneur provides the idea while the investor provides the money.[73] But that story is inadequate, as the investor could, in theory, simply buy the idea from the entrepreneur. (In some firms, of course, that is exactly what happens, but in many others it does not.) Only a model that includes principal costs – starting with principal competence costs – can explain why such investors hire managers.

In addition to scale economies, Jensen and Meckling mentioned a second reason why their model's manager might raise funding from an investor: diversification.[74] Even if the manager is wealthy enough to capitalize the firm at optimal scale himself, he can diversify away nonsystematic risk by allowing the investor to bear some of that risk instead. However, while the benefits of diversification help explain why investors might pool their funds when capitalizing a firm, they do not explain why those investors often delegate control to

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71 See, e.g., Bebchuk, Shareholder Power, supra note 9, at 851 (arguing that "shareholders should have power, subject to procedural requirements, to initiate and adopt rules-of-the-game decisions to amend the charter or to reincorporate in another state" and explaining why).

72 See Jensen & Meckling, supra note 2, at 313.

73 See, e.g., Philippe Aghion & Patrick Bolton, An Incomplete Contracts Approach to Financial Contracting, 59 Rev. Econ. Stud. 473, 475 (1992); Oliver Hart, Financial Contracting, 39 J. Econ. Literature 1079, 1079 (2001).

74 Jensen & Meckling, supra note 2, at 313 n. 15.

managers instead of running the firm jointly as copartners. Put more generally, neither of the explanations that Jensen and Meckling offered for capital pooling – scale economies and diversification – explains why investors frequently delegate control instead of sharing it collectively.

A theory of business firms that excludes principal costs also has difficulty explaining why, when investors do delegate control to managers, they often further agree to tie their own hands, voluntarily limiting their own rights to hold managers accountable. The most important accountability right is to replace the manager at will. Agency-cost essentialism suggests that an investor's power to replace a manager is extremely valuable for deterring self-seeking managerial conduct.[75] Yet many large business firms adopt structures that strictly limit shareholders' power to remove and replace managers. For example, the standard corporate form, which most public firms adopt, generally allows shareholders to replace corporate directors only once per year, at the annual shareholders meeting.[76] In addition, many firms adopt a staggered board whose members serve three-year terms and cannot be removed mid-term except for cause.[77] Private equity funds restrict the termination power even further: Investors typically have no right to replace managers, to whom they commit their funds for at least ten years.[78] Meanwhile, firms such as Google

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75 See, e.g., Bebchuk, Shareholder Power, supra note 9, at 899–901 (discussing how "insulation from takeover threats results in greater consumption of private benefits by executives").

76 See, e.g., Del. Code Ann. tit. 8, § 211(b) (2016).

77 See, e.g., id. § 141(d). In the S&P 500, however, staggered boards have lost prevalence, with only eighty-four companies currently holding staggered elections. Carol Bowie, ISS 2016 Board Practices Study, Harv. L. Sch. Forum on Corp. Governance & Fin. Reg. (June 1, 2016), http://corpgov.law.harvard.edu/2016/06/01/iss-2016-board-practices-study/ [http://perma.cc/JW5J-YA69].

78 See Steven N. Kaplan & Per Str.mberg, Leveraged Buyouts and Private Equity, 23 J. Econ. Persp. 121, 123 (2009) ("After committing their capital, the limited partners have little say in how the general partner deploys the investment funds, as long as the basic covenants of the fund agreement are followed.").

and Facebook have adopted dual-class-share structures that prevent public investors from replacing directors at all.[79] Agency-cost essentialism, under which investors hold control rights solely for the purpose of deterring managerial misconduct, struggles to explain why investors would place their capital with firms possessing such governance structures.

This shortcoming of an exclusive focus on agency costs can be seen in the Jensen-Meckling model itself. In the model, all of the investor's control rights serve to reduce agent conflict costs, and the exercise of any such right generates monitoring costs.[80] 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 otherwise avoids mistakes in the exercise of his control rights.[81] Therefore, he will incur the monitoring costs associated with the exercise of a control right when doing so reduces overall agency costs. In other words, he will

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79 See Alphabet Inc. & Google Inc., Annual Report (Form 10-K), at 85 (Feb. 11, 2016); Facebook, Inc., Annual Report (Form 10-K), at 25 (Jan. 28, 2016); 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 (on file with the Columbia Law Review); James Surowiecki, Unequal Shares, New Yorker (May 28, 2012), http://www.newyorker.com/magazine/2012/05/28/unequal-shares [http://perma.cc/H8ZW-M7PN]; Simon C.Y. Wong, Google's Stock-Split Plan Would Replace Stewardship with Dictatorship, Harv. Bus. Rev. (Apr. 18, 2012), http://hbr.org/2012/04/googles-stock-split-plan-would/ [http://perma.cc/B8T9-6YBU].

80 The original Jensen-Meckling model assumes that managers are homogeneous in their propensity to shirk and divert. See Jensen & Meckling, supra note 2, at 314. Given this assumption, replacing the manager would 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, agents must be heterogeneous in their propensity to act disloyally and investors must be unable to ascertain, at the time they hire the manager, that the manager's propensity is less than the propensity of other, equally competent manager candidates who might become available for hire.

81 See id. at 313 ("Prospective minority shareholders will realize that the ownermanager's interests will diverge somewhat from theirs[;] hence the price which they will pay for shares will reflect the monitoring costs and the effect of the divergence between the manager's interest and theirs.").

exercise a control right only when doing so is efficient. For this reason, the model's logic supplies no reason to limit the investor's powers, including the power to replace the manager at will.

Some scholars have invoked the notion of nonpecuniary benefits of control to explain why investors in some firms agree to tie their own hands.[82] The explanation assumes that managers differ in how much they intrinsically enjoy running the firm, and that managers who are especially fond of control are willing to give up some pecuniary compensation to obtain more of it. Such managers will therefore strike a deal with investors: The investors agree to limitations on their powers to hold managers accountable, in exchange for which the managers give the investors a larger share of the cash-flow rights, which the investors require to be willing to invest in a firm in which agency costs will presumably be high.[83]

A governance theory in which control-hungry managers trade pay for power may explain the division of control rights in some firms, but it is not a plausible explanation for the full range of governance structures that firms adopt, nor can it explain the financial performance of firms that allocate most control to managers. The theory implies that when returns to both investors and managers are taken into account, firms that tie investors' hands will, as a result of high agent costs, consistently generate lower returns on assets. As, however, we discuss in Part IV, firms with dual-class shares and other manager-empowering governance features do not, on average, deliver lower returns than firms lacking such features.[84] In short,

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82 The nonpecuniary benefits of control are an essential part of the Jensen-Meckling model. See id. at 312.

83 See Lucian Arye Bebchuk, A Rent-Protection Theory of Corporate Ownership and Control 3 (Nat'l Bureau of Econ. Research, Working Paper No. 7203, 1999), http://papers.ssrn.com/abstract=168990 (on file with the Columbia Law Review) (noting the common separation of cash-flow and voting rights and its implications for gaining control).

84 See infra section IV.A (arguing that there is no correlation across firms between governance structures and financial returns).

agency-cost essentialism, even when supplemented with a theory of managers who are heterogeneous in their love of control for its own sake, explains neither the variety nor the performance of governance structures that firms actually adopt. A satisfying explanation for the governance-control spectrum recognizes that investors can also generate conflict costs and, more fundamentally, that both investors and managers can generate competence costs.

II. Control Costs: The Problems of Competence and Conflict.

To produce firm value – meaning the value of the goods or services that a 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 an investor, a hired manager, or both, the creation of firm value requires that someone select the business strategy and then execute it by hiring (and, when necessary, 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.[85]

At the same time, the exercise of control also generates costs that sap firm value. Control costs can be categorized based on whose actions are the source of the cost (principals or agents) and on the problem that explains the cost (incompetence or conflict). With respect to the first distinction, we define principal costs as costs attrib-

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85 Additionally, the process of creating firm value can generate harmless nonpecuniary 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) [hereinafter Gilson, Complicating the Comparative Taxonomy] (defining nonpecuniary 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").

utable to the exercise of control by investors, and agent costs as costs attributable to the exercise of control by managers. With respect to the second distinction, we define competence costs as the costs of honest mistakes and of efforts to avoid such mistakes, and conflict costs as the costs of self-seeking conduct and of efficient efforts to prevent such conduct. We refer to *efficient* efforts to prevent self-seeking conduct because a cost resulting from, for example, over-spending on monitoring – such as the incurring of $100 in monitoring expenses to prevent only $50 in misconduct – would constitute a mistake and should therefore be considered a competence cost rather than a conflict cost.[86]

Combining the two distinctions yields 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 manner that minimizes the sum of costs across the four categories. Any shift of control among principals and agents entails tradeoffs among the categories, with the net effect of the shift – and thus the optimal control structure – depending on firm-specific characteristics.

Our distinction between principals and agents requires a note of clarification. We generally use the term *principal* to refer to an investor and *agent* to refer to a manager. In many firms, however, this distinction is blurred by the presence of managers who have also contributed capital.[87] One solution would be to define degrees of "principalness" and "agentness", but this would probably introduce more complexity than it is worth. To keep things simple, we define agents

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86 Just as an investor who overspends on monitoring generates principal competence costs, a manager who overspends on bonding generates agent competence costs.

87 See Kevin J. Murphy, Executive Compensation: Where We Are, and How We Got There, in 2A Handbook of the Economics of Finance 211, 217–18 (George M. Constantinides, Milton Harris & Rene Stulz eds., 2013) (reviewing the various ways that executive compensation can be measured).

as parties whose share of the discretionary control rights exceeds their share of the cash-flow rights, and principals as parties whose share of the cash-flow rights equals or exceeds their share of the discretionary control rights.[88] As applied to most corporate-governance structures, these definitions are workable and accord with common usage. Thus, although a principal-agent relationship exists between a corporation's board of directors and its officers, this Essay treats them as a unified agent. If the corporation is widely held, the shareholders are the principals; if instead the firm has a controlling shareholder (holding a control block either of common shares or of the vote-controlling shares in a dual-class share structure[89]), the controller is the agent along with the directors and officers, and the noncontrolling shareholders are the principals.[90] To be sure, when the parties share power in a more complicated division of control among investors and managers, it is harder to determine who has more control rights than cash-flow rights. But such arrangements are not common enough to negate the utility of the definitions of principal and agent we employ here.[91]

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

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88 This definition departs from the common-law definition of a principal–agent relationship, which requires as an "essential element" that the principal exercise ultimate control. 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). In this Essay's terminology, an investor who has no control rights is still a principal, and a manager who administers the investor's capital is still an agent.

89 See Goshen & Hamdani, supra note 14, at 591–92 (describing control-block arrangements and resulting costs).

90 In firms with dual-class shares, the noncontrolling shareholders include the shareholders holding the inferior shares as well as any minority holders of the superior shares. Id. at 590.

91 For example, minority shareholders who can affect a voting result (for example, by holding out) are still principals even though, with respect to the specific vote, their share of control may exceed their share of the cash-flow rights.

II.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 of the needed 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, as the investor could buy the idea from the would-be manager.[92] A more compelling explanation for the separation of ownership and control – the font of all conflict costs – is competence. Investors hire managers who can run a business more competently than they can, thereby increasing firm value.[93] Therefore, competence costs – or, more specifically, principal competence costs – are the problem that all governance structures are ultimately designed to solve.

II.A.1 Principal Competence Costs.

By delegating control to managers, investors reduce principal competence costs, at the inevitable price of higher 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, Mark, who wishes to use his personal wealth to build a stock portfolio. Although Mark could pick stocks himself, he lacks knowledge of business and finance and thus would make mistakes. He might pick

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92 See supra note 73 and accompanying text.

93 The idea of relative competence is similar to the well-known concept of the division of labor, according to which workers specialize in different tasks. See Gary S. Becker & Kevin M. Murphy, The Division of Labor, Coordination Costs, and Knowledge, in Human Capital: A Theoretical and Empirical Analysis with Special Reference to Education 299, 300–01 (3d ed. 1993). While most discussions of the division of labor focus on firms' internal operations, our discussion of competence costs is concerned with firms' governance structures.

stocks that are overpriced, fail to diversify, or incur avoidable taxes. None of these costs would result from a conflict of interests: Mark would be managing his own money and therefore internalizing all benefits and costs of his actions. His mistakes would not, in other words, result from shirking or diverting. They would be *honest* mistakes, resulting from a simple lack of competence.

To reduce the expected costs of his own mistakes, Mark could acquire the requisite expertise and information, but he would then incur opportunity costs.[94] And he still might make honest mistakes due to cognitive shortcomings, such as overconfidence and a lack of objectivity,[95] which investment in greater information and expertise might not correct. The costs of Mark's honest mistakes, as well as the costs of his efforts to make fewer mistakes while exercising control, would constitute competence costs – in particular, principal competence costs.[96] Put generally, principal competence costs can result from a lack of information and expertise (which can be acquired, but at a cost), and also from person-specific cognitive shortcomings (which may not be correctable at any cost).

To reduce principal competence costs, Mark could hire Peggy, a stock-market expert, to manage his portfolio. In this way, Mark would exploit the key economic benefits of the division of labor: He would assign tasks to a person who, perhaps through years of specialization, possesses information and expertise that permit her to make decisions more quickly and with fewer mistakes.[97] But the mere

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94 See generally Jeffrey M. Perloff, Microeconomics 186 (6th ed. 2012).

95 See generally Russell B. Korobkin & Thomas S. Ulen, Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics, 88 Calif. L. Rev. 1051, 1084–102 (2000) (explaining the effects of cognitive biases on behavior).

96 Legal scholars frequently cite differences in expertise and information as reasons that shareholders delegate authority to corporate boards. See, e.g., Donald J. Smythe, Shareholder Democracy and the Economic Purpose of the Corporation, 63 Wash. & Lee L. Rev. 1407, 1409 (2006) (noting that shareholders frequently lack expertise in, and knowledge of, corporations' business activities and thus are "quite content" to delegate authority to boards and executives).

97 The idea of the division of labor dates to the beginnings of economic theory. See Adam

hiring of Peggy will not eliminate all principal competence costs. Accountability costs, a form of principal competence costs, may arise. Mark is likely to retain certain control rights, such as the right to fire Peggy, in order to hold her accountable in her job performance. If the portfolio's performance under her control is lackluster, Peggy might try to save her job by telling Mark that the underperformance is temporary. At this point, Mark 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, the very lack of competence in evaluating stocks that led Mark to hire Peggy could 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).[98] The loss of value from such mistakes reflects principal competence costs.

Less drastically, Mark might force Peggy to submit regular performance reports that distract her from her work yet do little to improve Mark's decisionmaking.[99] Such overmonitoring would consti-

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Smith, The Wealth of Nations 3–23 (Edwin Cannan ed., Random House, Inc. 2000) (1776) (describing the origins, benefits, and limitations of the division of labor). Thereafter, the idea was developed to explore tradeoffs associated with specialization. See, e.g., Becker & Murphy, supra note 93, at 300–04 (exploring the relationship between specialization and coordination); Patrick Bolton & Mathias Dewatripont, The Firm as a Communication Network, 109 Q.J. Econ. 809, 810–11 (describing, in the context of information processing, the tradeoff between the efficiencies of agent specialization and increased communication costs); Sherwin Rosen, Specialization and Human Capital, 1 J. Lab. Econ. 43, 44 (1983) (exploring the relationship between specialization and private incentives). However, this literature, unlike this Essay, assumes that specialization enables all principals and all agents to reach the same levels of competence.

98 To protect herself, Peggy might select a portfolio that will never outperform the market but never temporarily underperform it either, or a portfolio composed of stocks whose merits she can easily explain to Mark. See, e.g., Sunil Wahal & John J. McConnell, Do Institutional Investors Exacerbate Managerial Myopia?, 6 J. Corp. Fin. 307, 326–27 (2000) (concluding "share ownership by institutional investors appears to allow US corporate managers to invest more in projects with long-term payoffs than would direct share ownership by individual investors" because individual investors are "less patient").

99 See Mike Burkart, Denis Gromb & Fausto Panunzi, Large Shareholders, Monitoring, and the

tute 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 Mark-Peggy relationship illustrates the sources of principal costs that are present even if a principal-agent relationship has only one principal. When principals exist as a group – as they do in a corporation with multiple shareholders – principal competence costs may be even higher. If investors exercise control rights jointly, then each will have to monitor the firm's operations and acquire the relevant expertise to make informed contributions to collective decisions. Such efforts are themselves competence costs, as their purpose is to avoid honest mistakes. Moreover, the efforts will largely be duplicative, as each investor will, with respect to any particular joint decision, seek to acquire the same expertise and information. It therefore may be efficient for the group to delegate decisionmaking to a collective agent, thereby reducing principal competence costs from duplicative efforts. Costs will fall even further if the selected agent already has the requisite expertise, which will enable the principals to exploit the benefits of specialization. In such a setting, there is a tradeoff between the principal costs that arise from collective decisionmaking and the agent costs that arise if control is concentrated in the hands of an individual acting on behalf of investors as a group.[100]

II.A.2. Agent Competence Costs.

Models concerned with the problem of agency costs tend to

Value of the Firm, 112 Q.J. Econ. 693, 693–94 (1997) (presenting a model of the tradeoff between monitoring and managers' investment incentives); see also Philippe Aghion & Jean Tirole, Formal and Real Authority in Organizations, 105 J. Pol. Econ. 1 (1997) (developing a seminal theory of the allocation of formal and real authority between a principal and an agent, and exploring the tradeoffs among agent incentives, communication costs, and principal control).

100 Group decisionmaking also entails coordination costs. See Hansmann, supra note 20, at 277–80 (analyzing the costs of collective decisionmaking).

assume that the only reason managers ever harm their firms is the misalignment of incentives caused by the separation of ownership and control.[101] But of course managers also make honest mistakes, generating agent competence costs. The magnitude of the costs will vary with the manager: Intelligent, informed, and unbiased managers make fewer mistakes than dull, ignorant, and biased managers. To return to the Mark-Peggy example, if Peggy picks a bad stock because she uses a flawed evaluation method, her mistake will be a source of agent competence costs. Similarly, if overconfident corporate managers are too optimistic about a proposed project,[102] their decision to devote corporate funds to the project will also generate agent competence costs. As Part III discusses, the types of accountability mechanisms that principals use to reduce agent competence costs tend to differ from those used to reduce agent conflict costs.

II.A.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 firm-specific characteristics determine the cost-minimizing division. Because the probability of a mistake depends on the competence levels of individual decisionmakers, investors who are knowledgeable about business matters will typically delegate less control to managers than those who are uninformed.

Competence can be activity specific. A hedge fund manager might be good at picking stocks and managing a portfolio but bad at

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101 This is, for instance, the essence of the Jensen-Meckling model. See Jensen & Meckling, supra note 2, at 308–10.

102 See Susanna Kim Ripken, Predictions, Projections, and Precautions: Conveying Cautionary Warnings in Corporate Forward-Looking Statements, 2005 U. Ill. L. Rev. 929, 958–65 (explaining manifestations and consequences of managerial overconfidence and optimism bias). See generally Korobkin & Ulen, supra note 95, at 1091–92 (explaining the effects of overconfidence biases).

running a company. Similarly, an entrepreneur might be good at identifying business opportunities but bad at managing people. We can expect organizations to allocate control accordingly.[103]

A firm's overall competence in decisionmaking might also depend on the type of business the firm is engaged in. Mistakes are more likely in firms that are complex in terms of size, technology, or geographic scope of operations. Complexity makes honest mistakes more likely and challenges investors by impeding the evaluation of managerial performance.[104] Therefore, when a firm is in a complex industry, its investors are more likely to make mistakes when evaluating managers and deciding whether to replace them.[105] Similarly, when investors use a firm's public stock price as a performance proxy, market imperfections can lead investors to misevaluate managerial competence and loyalty.[106]

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103 See, e.g., Viral V. Acharya, Marc Gabarro & Paolo F. Volpin, Competition for Managers, Corporate Governance and Incentive Compensation 29 (May 2012) (unpublished manuscript), http://pages.stern.nyu.edu/~sternfin/vacharya/public_html/AGV_paper_110512.pdf [http://perma.cc/RB9D-N8AP] ("[W]hen managerial ability is observable and managerial skills are scarce, competition among firms to hire better managers implies that in equilibrium firms will choose lower levels of corporate governance.").

104 See, e.g., Mustafa Ciftci, Baruch Lev & Suresh Radhakrishnan, Is Research and Development Mispriced or Properly Risk Adjusted?, 26 J. 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, 151 (1990) (observing that the complexity of long-term projects leads managers to pursue short-term projects that are easier for outsiders to evaluate).

105 Managers will account for this risk by limiting investors' right to replace them. This can explain why we observe more dual-class share structures among high-tech firms such as Google, Facebook, and LinkedIn. For a similar analysis, see Goshen & Hamdani, supra note 14, at 590 (discussing examples of prominent technology corporations that utilize dual-class share structures and noting that such structures "provide[] the entrepreneur with maximum ability to realize her idiosyncratic vision").

106 Markets may become imperfect due to misevaluations (e.g., insufficiently informed trading) or limits on arbitrage (e.g., inefficient or myopic markets). See, e.g., 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, 308 (1990) (arguing "market-efficiency anomaly is rooted in a failure of information to flow completely into price"); Lynn A. Stout, The Mechan-

Besides differing in probability, control mistakes can differ in magnitude. Important determinants of a mistake's magnitude include the levels of competition in the firm's product market and in the input markets where the firm acquires capital, materials, and employees.[107] A mistake could either bankrupt a firm or barely dent its earnings, depending on whether the markets in which it operates are competitive or monopolistic.[108]

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 more expertise and information.[109] Some mistakes will, however, be unavoidable, in the sense that their expected costs are less than the costs of avoiding them.[110]

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isms of Market Inefficiency: An Introduction to the New Finance, 28 J. Corp. L. 635, 653–55 (2003) (describing a "delayed and incomplete market response" to major announcements and discussing real-world factors that limit the power of arbitrage).

107 See, e.g., How Bad Decisions Can Lead to Billion-Dollar Mistakes, Knowledge@Wharton (Feb. 22, 2001), http://knowledge.wharton.upenn.edu/article/howbad-decisions-can-lead-to-billion-dollar-mistakes/ [http://perma.cc/RE7F-TY2W] (noting that a rush at Barings Bank to capitalize on market opportunities caused executives to fail to implement sufficient oversight mechanisms, contributing to the bank's collapse).

108 See, e.g., Douglas A. McIntyre et al., The Worst Business Decisions of All Time, 24/7 Wall St. (Oct. 17, 2012), http://247wallst.com/special-report/2012/10/17/the-worstbusiness-decisions-of-all-time/2/ [http://perma.cc/8374-XHE7] (providing examples, such as at Motorola, of circumstances in which market changes exacerbated the consequences of bad business decisions).

109 The management-consulting industry is built on this need. See About Us, McKinsey & Company, http://www.mckinsey.com/about-us/overview [http://perma.cc/2XC7-S9VS] (last visited Nov. 2, 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.").

110 This is the same idea underlying the definition of negligence in the law-and-economics literature. See, e.g., Richard A. Posner, A Theory of Negligence, 1 J. Legal Stud. 29, 33 (1972) ("When the cost of accidents is less than the cost of prevention, a rational profit-maximizing enterprise will pay tort judgments to the accident victims rather than incur the larger cost of avoiding liability.").

Because mistakes can result from managers' intellectual and emotional endowments, the mistakes 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 hiring a replacement.

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

Conflict costs – the fixation of agency-cost essentialists[111] – are a derivative form of control costs, as they arise only when investors attempt to reduce competence costs by delegating control to managers. A sole proprietor who runs his own business generates competence costs but not conflict costs.[112] Rather, conflict costs – the result of intentional, self-seeking conduct in the operation of a business firm – arise only when parties share control, cash flows, or both.

II.B.1. Principal Conflict Costs.

Principal conflict costs result from investor self-seeking conduct attributable to the separation of ownership and control. While they can arise even when a business relationship has just one principal (along with one or more agents), they are more likely to be a significant problem when a firm has multiple principals with conflicting interests.

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111 See supra note 18 and accompanying text.

112 But see Robert Louis Stevenson, Strange Case of Dr. Jekyll and Mr. Hyde (Canongate 1986) (1886). We assume that real-world actors do not suffer from internal conflicts of the Jekyll-and-Hyde variety.

Scholars have described several sources of conflict among shareholders, including differing investment horizons[113] and needs for cash payouts,[114] empty voting,[115] and competing outside interests.[116] Additionally, when principals form a group, conflict costs arise from collective-action problems such as holdouts,[117] rational apathy,[118] rational reticence,[119] and strategic voting,[120] all of which are caused by the division of control rights among multiple parties.

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113 See José Miguel Gaspar, Massimo Massa & Pedro Matos, Shareholder Investment Horizons and the Market for Corporate Control, 76 J. Fin. Econ. 135, 138 (2005) (noting that "it does make a difference who the shareholders are" because "managers face a tradeoff between targeting acquiescent short-term shareholders who are not committed to the company and targeting demanding long-term shareholders who can give them a strong hand at a merger negotiation table").

114 See Deborah J. Lucas & Robert L. McDonald, Shareholder Heterogeneity, Adverse Selection, and Payout Policy, 33 J. Fin. & Quantitative Analysis 233, 240–41 (1998) (illustrating the "nature of possible conflicts among shareholder clienteles about the firm's dividend/repurchase policy").

115 Henry T.C. Hu & Bernard Black, The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership, 79 S. Cal. L. Rev. 811, 816–17, 894 (2006) (discussing the consequences of decisionmaking when separating voting rights from equity ownership).

116 See, e.g., Bainbridge, Shareholder Disempowerment, supra note 34, at 1745 n.54 (explaining that shareholder interests are "insufficiently homogenous to allow the use of shareholder-centered, consensus-based forms of corporate decisionmaking").

117 See Zohar Goshen, Controlling Strategic Voting: Property Rule or Liability Rule?, 70 S. Cal. L. Rev. 741, 753–56 (1997).

118 See Adolf A. Berle Jr. & Gardiner C. Means, The Modern Corporation and Private Property 86–87 (1932) (describing minority shareholders' lack of influence in dispersed ownership situations, which causes them to abstain from voting or assign their vote to a proxy); Bainbridge, Shareholder Disempowerment, supra note 34, at 1745.

119 See Gilson & Gordon, supra note 61, at 889–95 (addressing the reasons that "[m]utual funds and other for-profit investment managers are almost uniformly reticent").

120 See Lucian Arye Bebchuk, Toward Undistorted Choice and Equal Treatment in Corporate Takeovers, 98 Harv. L. Rev. 1693, 1720–23 (1985) [hereinafter Bebchuk, Undistorted Choice] (describing shareholders' considerations in making a tender decision); Jeffrey N. Gordon, Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 76 Calif. L. Rev. 3, 47–55 (1988) ("[A]pproval of a recapitalization can be driven by strategic considerations that distort shareholder choice rather than by a collective judgment that approval is optimal for public shareholders.").

To obviate principal conflict costs, investors often transfer control to a common agent.[121] As an illustration, suppose that a group of investors hires Peggy to manage the group's investments and that Peggy identifies an investment project that would tie up the investors' capital for several years but ultimately generate a superior return. It is in the investors' collective interest that Peggy pursue the project.[122] However, suppose further that, one year into the project, Mark needs an immediate cash distribution. If Mark could force such a payout, and the fund must therefore liquidate the long-term project prematurely, he will impose a loss on the other investors. Such a loss would constitute a principal conflict cost. Anticipating this possibility, the investors might collectively agree to waive their liquidation rights for fixed periods.[123] But by waiving this control right, they would lose a device for holding Peggy accountable.

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 it website to propose a change in its business strategy. Once a proposal appears, holders of a simple majority of shares can approve it by online voting.[124] The corporation has man-

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121 See generally Kenneth J. Arrow, The Limits of Organizations 69–70 (1974) (noting that when a group of principals has conflicting interests, the principals prefer that decisions be made through delegation rather than by consensus).

122 See generally Richard Brealey et al., Principles of Corporate Finance 105–09 (11th ed. 2014) (explaining the concept of net present value).

123 Indeed, this is the common structure of private equity funds. See Kaplan & Stromberg, supra note 78, at 123. For the historical development of the capital lock-in feature in corporations, see Giuseppe Dari-Mattiacci et al., The Emergence of the Corporate Form 4–20 (Amsterdam Ctr. for Law & Econ., Working Paper No. 2013-02, 2013), http://ssrn.com/abstract=2223905 (on file with the Columbia Law Review).

124 The Delaware General Corporation Law authorizes this type of governance structure for corporations, permitting the certificate of incorporation to provide for management directly by

agers, but their only task is to implement business plans that the shareholders endorse. 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 have dispersed views, conflicting interests, and differing investment horizons.[125] 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.[126] 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 prin-

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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 otherwise 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 of incorporation"). 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(h) (Nat'l Conference of Comm'rs on Unif. State Laws 2013) ("Each partner has equal rights in the management and conduct of the partnership's business."); Unif. Ltd. Liab. Co. Act §§ 407(a)–(b) (Nat'l Conference of Comm'rs on Unif. State Laws 2013) (providing that a limited liability company is "member-managed" by default and vesting "management and conduct" of member-managed companies in the members).

125 See supra notes 113–116 and accompanying text.

126 Diversified investors who hold a small fraction of the equity of numerous companies are rationally apathetic about management decisions. While the rise of institutional investors, which hold large positions in many companies and are devoted to overseeing their investments, might suggest a decline in apathy, these investors have proven to be reticent to interfere with management. See Gilson & Gordon, supra note 61, at 889–95 (explaining 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, Hedge Funds, supra note 61, 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).

cipal 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 that give equity investors direct control over strategic decisions are found only in sole proprietorships, small partnerships, and some closely held corporations.[127] 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,[128] and federal law follows suit by permitting public firms to exclude from annual proxy statements shareholder proposals related to the company's ordinary business operations, even if the proposals are framed in precatory terms.[129]

II.B.2. Agent Conflict Costs.

Agent conflict costs – which are what Jensen and Meckling, in disregard of competence costs, simply called agency costs[130] – are byproducts of principal costs: They arise when investors, in order to reduce principal costs, delegate control. Corporate law scholar have identified a wide variety of behaviors that are sources of agent con-

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127 See, e.g., Robert W. Hillman, Power Shared and Power Denied: A Look at Participatory Rights in the Management of General Partnerships, 1984 U. Ill. L. Rev. 865, 865–66 (discussing the participatory rights of partners); Venky Nagar, Kathy Petroni & Daniel Wolfenzon, Governance Problems in Closely Held Corporations, 46 J. Fin. Quantitative Analysis 943, 943–47 (2011) (measuring the effects of shareholder participation in closely held firms).

128 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).

129 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. 1547, 1558–59 (2016) (arguing that the ordinary-business-operations exclusion tracks the distinction under state law between the roles of shareholders and managers).

130 See Jensen & Meckling, supra note 2, at 308–10.

flict costs, including entrenchment,[131] merging for size,[132] merging for diversification,[133] excessive or inefficient pay,[134] self-dealing,[135] tunneling,[136] and options backdating.[137] All such actions are forms of shirking or diverting, and all occur when managers do not own the rights to all of their firms' cash flows and thus do not bear the full costs of their decisions when they exercise control.

II.B.3. A Firm's Total Conflict Costs.

What causes some firms to incur greater conflict costs than others? The expected magnitude of self-seeking conduct by investors and managers – and thus the expected 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.[138] A party's opportunity to misbehave, in

131 See Andrei Shleifer & Robert W. Vishny, Management Entrenchment: The Case of Manager-Specific Investments, 25 J. Fin. Econ. 123, 123–24 (1989) (discussing how managers "counter disciplinary forces by entrenching themselves").

132 See William J. Baumol, On the Theory of Expansion of the Firm, 52 Am. Econ. Rev. 1078, 1078 (1962) (noting "management's occupation with growth").

133 See Yakov Amihud & Baruch Lev, Risk Reduction as a Managerial Motive for Conglomerate Mergers, 12 Bell J. Econ. 605, 615–16 (1981) (analyzing diversification as an explanation for conglomerate mergers).

134 See Bebchuk & Fried, supra note 56, at 88–89 (weighing the costs to shareholders when managers influence their own pay).

135 See Austin W. Scott, The Fiduciary Principle, 37 Calif. L. Rev. 539, 544–45 (1949) (discussing breaches of fiduciary duties in self-dealing transactions).

136 See Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, Unbundling and Measuring Tunneling, 2014 U. Ill. L. Rev. 1697, 1698–99 (examining four types of tunneling and evaluating their effects on firm performance).

137 See Erik Lie, On the Timing of CEO Stock Option Awards, 51 Mgmt. Sci. 802, 803–04 (2005).

138 See Jensen & Meckling, supra note 2, at 314.

turn, depends on the allocation of control rights,[139] the type of firm,[140] and the intensity of market competition.[141] 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 of these factors affect the probability and magnitude of self-seeking behavior, the expected sum of conflict costs is firm-specific. For example, conflict costs will be relatively high 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 be firm-specific as well.[142]

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139 The scope of authority, the bonding and monitoring methods employed, and other devices for curtailing control can limit the agent's ability to get away with shirking or diverting, but, at the same time, they will decrease the agent's ability to manage efficiently. See, e.g., Ricardo Alonso & Niko Matouschek, Optimal Delegation, 75 Rev. Econ. Stud. 259, 263–67 (2008) (offering a formal model of the delegation dilemma—delegating more control rights to an agent results in higher agent costs yet higher performance, while delegating fewer control rights to an agent results in lower agent costs yet lower performance).

140 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 C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 Am. Econ. Rev. 323, 323 (1986) ("Conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free cash flow. The problem is how to motivate managers to disgorge the cash rather than investing it at below the cost of capital or wasting it on organization inefficiencies.").

141 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 et al., Product Market Competition and Corporate Governance, 1 Rev. Dev. Fin. 114, 115–16 (2011) (finding that "corporate governance quality has a significant effect on performance only when competition is weak" and concluding that "fear of liquidation compels managers to put forth their best efforts for their firms"); Maria Guadalupe & Francisco Pérez-González, Competition and Private Benefits of Control 26 (Mar. 2010) (unpublished manuscript), http://ssrn.com/abstract=890814 (on file with the Columbia Law Review) (finding that product-market competition "significantly and consistently affects ... estimates for the value of being in control").

142 As the level of misconduct depends on the personal characteristics of the actor, the type of firm, and the level of market competition, so do efforts to reduce misconduct.

II.C. Synthesis: The Control-Cost Matrix.

	Competence Costs	Conflict Costs
Principal	- Lack of expertise - Inadequate information - Lack of intelligence - Poor emotional control - Duplicative efforts - 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

The table lists specific sources of each of the four types of control costs. When a sole proprietor delegates no control to managers, the only potential control costs are principal competence costs (at top left in the table). When investors form a group, such as in a partnership, principal conflict costs (at top right in the table) are also possible. If those investors instead delegate all control rights to a manager, such as in a foundation or trust,[143] principal costs are avoided, but agent competence costs and agent conflict costs (the two bottom cells in the table) become possible. Finally, when investors share control with managers, as in most business corporations, the exercise of control can generate all four types of control costs.

143 See, e.g., Henry Hansmann & Steen Thomsen, Managerial Distance and Virtual Ownership: The Governance of Industrial Foundations 5–6 (European Corp. Governance Inst., Working Paper No. 372, 2013), http://ssrn.com/abstract=2246116 (on file with the Columbia Law Review) (describing and analyzing industrial foundations' performance and functions).

III. Theory of Principal Costs.

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 total control costs: the sum of principal competence costs, principal conflict costs, agent competence costs, and agent conflict costs. We therefore can presume that, absent a market failure or prohibitive transaction costs,[144] each firm has a governance structure that suits its firm-specific characteristics.

III.A. The Tradeoff Between Principal Costs and Agent Costs.

The allocation of control rights in a firm is a zero-sum proposition. Any reallocation of control rights reduces the power of some parties while increasing 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 responsibility for one or more components to managers. Moreover, if they delegate control to managers, they could 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

144 See 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 better off unless there is a market failure); R.H. Coase, The Problem of Social Cost, 3 J.L. & Econ. 1, 15–19 (1960) (discussing the effect of transaction costs); Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, 89 Geo. L.J. 439, 467 (2001) [hereinafter Hansmann & Kraakman, End of History] (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) (describing different types of market failure).

final authority over particular decisions while simultaneously delegating full and final authority over those decisions to managers.

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, transferrin more control to managers, principal costs fall but agent costs rise; shifting control from managers to investors has the opposite effect. But the impact of such movements on principal costs and agent costs need not fully offset: Shifting control from investors to managers might decrease principal costs more than it increases agent costs. In theory, there is a point along the control spectrum at which the sum of principal and agent costs is at a minimum – a point achieved by a particular governance structure that varies across firms.

As an illustration, imagine a firm in which investors hold 100% of the control rights and are deciding whether to delegate 1% of those rights to managers. Delegation would decrease expected principal costs – assume by $100. And it would increase expected agent costs, but perhaps not by as much – assume by $50. Therefore, delegation of 1% of the control rights would increase firm value by $50. It follows that the investors will favor the delegation: As holders of the cash-flow rights, they capture the increase in firm value that the delegation achieves.

It is possible that delegation in some firms continues to be efficient across the entire delegation range.[145] In those firms, we can expect investors to delegate all control rights to managers, as the sum of principal costs and agent costs reaches its nadir when the manag-

145 For instance, we can expect such a tradeoff in firms with complex technologies (such as Google, Facebook, and LinkedIn) or with complex and unique business strategies (such as Berkshire Hathaway). In these firms, principal costs are expected to be very high.

ers have full control. Such firms would achieve their maximum value by selecting a governance structure, such as the dual-class share structure, that assigns a high degree of control to managers.[146]

At the opposite extreme are firms in which delegation increases total control costs throughout the delegation range. In such firms, any incremental transfer of control to managers increases expected agent costs more than it reduces expected principal costs. Such firms minimize control costs by placing all control in the hands of investors. If they were public companies, they would adopt governance structures resembling direct democracy.[147] Because public companies never actually adopt such structures, 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 exist exclusively in smaller firms such as sole proprietorships, as well as partnerships in which the partners retain full control over business decisions.[148]

Finally, there are many firms in which delegation is initially cost effective but eventually becomes inefficient as more control is shifted to managers. These firms maximize value by adopting governance structures that delegate a large measure of control to managers but also empower the investors to hold the managers accountable. One such structure is the corporation with dispersed ownership.[149]

III.B. Delegation and Accountability Rights.

While control structures differ in terms of the degree of dele-

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146 See Goshen & Hamdani, supra note 14, at 590–91 (explaining the potential benefits of the dual-class share structure for firms in which managerial "idiosyncratic vision" is important).

147 See supra notes 124–129 and accompanying text.

148 See, e.g., Royston Greenwood & Laura Empson, The Professional Partnership: Relic or Exemplary Form of Governance?, 24 Org. Stud. 909, 916–17 (2003) (explaining the success of partnerships of professionals).

149 See Goshen & Hamdani, supra note 14, at 589.

gation, they also differ in the form that delegation takes.[150] In particular, structures vary in terms of the types of control rights that investors retain in order to hold managers accountable in their exercise of delegated control. There are many types of retained accountability rights; we limit ourselves here to identifying some of the most prominent examples and discussing their relationship to the distinction between competence costs and conflict costs.

Retained accountability rights can usefully be divided into two general categories: duty-enforcement rights and discretionary rights. Duty-enforcement rights permit a principal to sue an agent for breach of a restriction on the agent's exercise of control. The source of the restriction could be a statute (such as a general incorporation law[151]), a contract (such as a bond indenture with covenants[152]), or the common law (such as the law of fiduciary duties,[153] which requires agents to disclose conflicts of interest, refrain from self-dealing, and make decisions on an informed basis[154]). In addition, the restriction can take the form of a standard, such as the duty to act in good faith,[155] or

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150 Delegation can occur along multiple dimensions. One 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, while allowing those managers to select the subagents, such as the CEO and other officers.

151 See, e.g., Del. Code Ann. tit. 8, § 141 (2016).

152 See Clifford W. Smith, Jr. & Jerold B. Warner, On Financial Contracting: An Analysis of Bond Covenants, 7 J. Fin. Econ. 117, 151 (1979) ("The debt contract typically gives the firm a strong incentive to live up to the restrictive covenants: any breach of the covenants is considered an act of default.").

153 See Aronson v. Lewis, 473 A.2d 805, 808 (Del. 1984) (holding that pre-suit demand on the board in the context of a derivative suit is "excused where facts are alleged with particularity which create a reasonable doubt that the directors' action was entitled to the protections of the business judgment rule").

154 These duties are, of course, the basis for corporate law's duties of loyalty and care. See, e.g., William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 56 Bus. Law. 1287, 1290–91 (2001).

155 See In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 62–68 (Del. 2006).

a rule, such as a covenant that specifies a firm's maximum leverage ratio.[156]

Regardless of the form that a duty-enforcement right takes, the process for the right's creation and enforcement is the same: First, a restriction on the agent's exercise of control is established; second, the agent violates the restriction; third, the principal sues for relief. Although principals have discretion over whether to *seek* relief, they do not have discretion over whether to *grant* relief: That discretion is vested in a court, which decides whether the agent violated the applicable rule or standard.

The primary function of duty-enforcement rights is to reduce conflict costs.[157] Such rights are not normally used to reduce competence costs, as it is difficult to prove to a judge that a firm's underperformance resulted from unwise managerial decisions rather than bad luck.[158] The deferential business judgment rule reflects judicial reluctance to evaluate managerial competence, as contrasted with managerial loyalty.[159]

The second category of retained accountability rights – discretionary control rights – are rights that principals may exercise without first having to prove that the agent violated an established restriction.

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156 See Smith & Warner, supra note 152, at 131–35 (describing and modeling bond covenants that "indirectly restrict production/investment policy").

157 These are the rights that Jensen and Meckling probably had in mind when they discussed how the investor in their model might bargain for monitoring rights to reduce the direct costs of agent misconduct. See supra text accompanying note 51. 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.

158 William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem, 96 Nw. U. L. Rev. 449, 454–55 (2002) (explaining the difficulty of enforcing the duty of care).

159 The business judgment rule provides that disinterested and well-informed corporate directors are not liable to the corporation for making negligent business decisions. See Aronson v. Lewis, 473 A.2d 805, 811–13 (Del. 1984).

In the enforcement of such rights, there is no distinction between seeking the relief and granting it: The principals' exercise of discretion encompasses both. Discretionary rights can be collective or individual. Paradigmatic examples of collective rights include the rights of corporate shareholders to select and replace directors[160] and to vote on proposed mergers.[161] Individual discretionary rights include the investor's right to withdraw capital from a hedge fund or mutual fund.[162]

Like duty-enforcement rights, discretionary rights can reduce agent conflict costs. But that is not their primary function. Rather, they are used mainly to constrain agent competence costs, as duty-enforcement rights are ill-suited to this task.[163] Thus, if principals have a

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160 See Del. Code Ann. tit. 8, § 141(k) (2016) (providing for the removal of directors by majority shareholder vote). 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 rule or standard—that they self-dealt, acted in bad faith, or were objectively incompetent. The shareholders can act entirely on their own accord. Id. (authorizing shareholders to remove directors "with or without cause"). 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 board-approved merger, dissolution, or sale of all assets. See id. §§ 251, 271, 275 (providing for procedures of dissolution). Corporate charters can empower shareholders to veto other transactions as well. See id. § 141(a). To do so, 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 best interest. Id. Conversely, investors can waive their right to veto fundamental transactions by forming a limited liability company (LLC). See, e.g., Revised Unif. Ltd. Liab. Co. Act § 110 (Nat'l Conference of Comm'rs on Unif. State Laws 2013) (providing that an LLC operating agreement may broadly alter default rules). State LLC statutes do not mandate investor ratification of any particular business transaction, permitting the parties to allocate this control right as they see fit. Id.

161 See, e.g., Goshen, supra note 117, at 749–51 (discussing strategic voting by shareholders and the majority rule).

162 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). 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.

163 The Jensen-Meckling model grants the investor no discretionary control rights precisely

right to replace an agent for incompetence, they may do so without restriction.

Unlike duty-enforcement rights, whose primary function is to mitigate agent conflict costs, discretionary rights reduce both agent conflict costs and agent competence costs; they therefore have greater capacity to curb total agent costs. But there's a catch: They also entail higher principal costs. For example, corporate shareholders with the discretionary power to veto mergers proposed by directors could make honest mistakes that reduce firm value. And a subgroup of shareholders could use the discretionary veto power to extract value from other shareholders by holding out.[164] Duty-enforcement rights, by contrast, are less disruptive of business operations, entailing lower principal costs.[165] Accordingly, they are less effective at reining in agent costs.

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 receive its cash flows or sell them to others, maximize their wealth when they

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because the model assumes away competence costs. The model's manager can act disloyally, but he never makes honest mistakes. See supra section I.B.

164 See, e.g., Schreiber v. Carney, 447 A.2d 17, 25–26 (Del. Ch. 1982) (holding that a corporation's loan to a shareholder made conditional on its vote in favor of a pending merger was not per se illegal).

165 The potential for a duty-enforcement right to disrupt depends on whether it may be exercised only periodically or instead at any time. For example, a mandatory-dividend requirement, which is periodic in nature, does not interfere with managers' power to select and implement the firm's business strategy. It merely limits the managers' control over profits, enabling investors to decide whether to reinvest them with the managers or deploy them elsewhere. Mandatory dividends are often found in master limited partnerships, see, e.g., Matthew J. McCabe, Comment, Master Limited Partnerships' Cost of Capital Conundrum, 17 U. Pa. J. Bus. L. 319, 327 (2014), and in real estate investment trusts, see William Hardin III & Matthew D. Hill, REIT Dividend Determinants: Excess Dividends and Capital Markets, 36 Real Est. Econ. 349, 351 (2008).

select the firm-specific allocation of control rights that minimizes total control costs.

III.C. Understanding the Governance Spectrum.

Agency-cost essentialism can explain neither of the dimensions along which governance structures vary: the degree to which they delegate control to managers, and the degree to which they enable investors to hold managers accountable for the exercise of that control.[166] For example, essentialism cannot explain why, even in wholly-owned firms, investors delegate authority to managers, as doing so creates agent conflict costs, the bête noir of the essentialists. 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 control to managers to reduce the competence costs, and sometimes the conflict costs, that they would generate if they ran the firm entirely themselves. For example, a highly competent businessperson who owns multiple businesses might hire managers to run some of those businesses if the opportunity costs that the owner would have to incur to avoid mistakes in running those businesses is higher than the opportunity costs that the managers incur. In this way, a model of firm governance that includes principal competence costs can incorporate the economic theory of comparative advantage.

Principal costs also explain why investors often agree to restrictions on their powers to hold managers accountable. A common such restriction is on the power to fire managers.[167] Shareholders in

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166 Cf. Arrow, supra note 121, at 79 ("Clearly, there is no consensus on the need for responsibility and certainly not on its scope or on the mechanisms for its achievement.").

167 See Bebchuk, Insulating Boards, supra note 63, at 1679–81 (explaining the costs associated with board insulation).

business corporations consent to a structure that permits them to replace directors only once per year, absent extraordinary circumstances.[168] Agent-cost theory suggests that shareholders should want the power to replace directors at any point. But once principal costs are also taken into account, at-will director employment is no longer a self-evident ideal.

Understanding why shareholders would voluntarily tie their own hands starts 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 managers. One potential cause is self-seeking managerial conduct (shirking and diverting) that generates agent conflict costs.[169] A second is imperfections in the performance measurement, such as short-term market mispricing of publicly traded shares.[170] A third possibility is bad luck.[171] Finally, suboptimal performance might be due to a pattern of honest managerial mistakes, reflecting agent incompetence. Only the last of these possibilities provides clear grounds for firing managers. If the managers are self-seeking but otherwise competent, the optimal solution might 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 reliably acted prudently and honestly, there would be no reason for them to agree to limit or waive their power to fire managers. But most investors do not fit this description. Most investors could misattribute disloyalty, bad measure-

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168 See id. at 1654–56; cf. Del. Code Ann. tit. 8, § 141(k) (2016) (providing that shareholders may remove members of classified boards only for cause unless the charter provides otherwise).

169 See supra section II.B.2.

170 See Aydodan Alti & Paul C. Tetlock, Biased Beliefs, Asset Prices, and Investment: A Structural Approach, 69 J. Fin. 325, 326 (2014) (identifying overconfidence and overextrapolation as performance-based causes of mispricing by shareholders).

171 In any particular context, even the shrewdest business strategy will have some probability of failure.

ments, or bad luck to incompetence, and then generate principal costs by firing a competent manager.

When investors confront the question whether to replace the managers of an underperforming firm, a complicating factor is that the managers often know more than the investors about why the firm is faltering. The managers will know if they acted disloyally, and they will have a good sense of whether the performance measurement is accurate. Because, however, managers might be dishonest, investors might distrust the explanations they offer. Therefore, investors will rationally expect managers to overattribute poor performance to distorted measurements and bad luck, and underattribute it to incompetence and disloyalty. However, in second-guessing managers, investors will sometimes make honest mistakes: They will sometimes misdiagnose the cause of underperformance and replace managers who are, despite the firm's poor performance, in fact loyal and competent. Notably, the converse problem can also arise: Incompetent investors might fail to fire incompetent managers because good luck or a distorted performance measure makes the managers seem more competent than they really are.

Anticipating the risk of false negatives – of being fired despite their competence – managers could respond in a variety of ways. They could demand a higher salary as compensation for the risk. They also could avoid profitable but complex business strategies that are prone to mismeasurement.[172] In Mark and Peggy's hypothetical principal-agent relationship, Peggy might refrain from picking undervalued stocks that will take time to appreciate in value, instead investing Mark'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 an-

172 See, e.g., Mustafa Ciftci, Do Analysts Underestimate Future Benefits of R&D?, 5 Int'l Bus. Res., Sept. 2012, at 26, 35 (finding "analysts underestimate earnings long term growth for [research-and-development]-intensive firms").

ticipatory 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 might include an agreement by the investors to tie their own hands.[173] For example, the investors might agree to give managers a long period during which they cannot be fired without cause, emboldening the managers to pursue profitable long-term projects that are subject to short-term mismeasurement.[174]

A desire to avoid principal conflict costs is a second reason why investors might accede to limits on their power to replace managers. For example, Peggy might refuse to work for Mark, despite an offer of 50% of the returns from the portfolio while she manages it, if she fears that Mark, in order to capture 100% of the continuing earnings for himself, will opportunistically fire her after she selects a high-value portfolio. Mark might then find it beneficial to guarantee Peggy employment for a minimum period. In essence, Mark would be bonding himself to Peggy with the expectation that the bonding cost is less than the other principal conflict costs thereby avoided. Similarly, in a firm with multiple investors, conflicts between investors with short horizons and those with long horizons would generate principal conflict costs. Such costs would arise if the short-termers pressured management to run the firm in a way that temporarily

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173 Jack Jacobs, former Justice of the Delaware Supreme Court, has suggested that state incorporation statutes should be amended to allow firms to replace annual director elections with elections every three or five years. Jack B. Jacobs, "Patient Capital": Can Delaware Corporate Law Help Revive It?, 68 Wash. & Lee L. Rev. 1645, 1660–61 (2011).

174 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 managers of noninterference exceeds the value that the investors place on the power to interfere. Such a bargain will be possible if, for example, managers believe that they are more competent or loyal than the investors perceive them to be.

boosted its stock prices but reduced its long-term value.[175] 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.

In a division of control negotiated between investors and managers, expected principal costs and agent costs will determine whether, and at what intervals, the investors have the power to replace the 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 – have the converse implications. In this way, principal-cost theory explains why real firms adopt a range of governance structures that differ in (among other structural elements) the frequency with which they allow investors to replace managers.

III.D. Structures Along the Spectrum.

The different degrees of control that investors can exercise over managers produce a spectrum of governance structures. The investor-controlled "direct democracy" sits at one pole, while the manager-controlled corporation with dual-class shares sits at the other.[176]

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175 Scholars and other commentators have debated whether, and to what extent, this conflict exists in public corporations. The contestants in the debate present both theoretical models and empirical evidence. For arguments criticizing the claim that increased shareholder control elevates the pursuit of short-term value at the expense of long-term value, see Bebchuk et al., Long-Term, supra note 63, at 1088–89 (concluding an empirical study does not support the "myopic-activist" claim); Bebchuk, Insulating Boards, supra note 63, at 1644 (rejecting the short-termism claim that insulating boards serves long-term value and arguing that shareholders' ability to intervene and engage creates long-term value); cf. Roe, supra note 61, at 1005 (finding no support for claims that short-term trading undermines corporate decisionmaking and concluding that "the evidence that financial markets are excessively short-term is widely believed but not proven").

176 See Goshen & Hamdani, supra note 14, at 587–88 (explaining "the spectrum of ownership patterns").

The dispersed-ownership structure, the most common arrangement among American public companies, falls in the middle. The following discussion considers three of the most important governance structures that public firms adopt – the dual-class share structure, the concentrated-ownership structure, and the dispersed-ownership structure – and assesses the tradeoff between principal costs and agent costs struck by each.[177] Other common governance arrangements, such as the standard private equity fund and the traditional partnership, could be slotted at various points along the spectrum.

III.D.1. The Dual-Class Share Structure.

In a corporation with dual-class shares, the controllers are managers who own shares with superior voting rights, while outside investors hold shares with inferior voting rights.[178] Google and Facebook notably went public with this structure.[179] The outside share-

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177 Market failure may also explain why some allocate control rights differently. For example, managers may sometimes 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, 92 Am. Econ. Rev. 460, 469–70 (2002). Thus, managers might be able to convince investors that a high degree of delegation is appropriate by withholding critical information that would show that they are not as honest or talented as the investors think they are.

178 As an illustration, imagine a firm that has Class A shares with 51% of the votes but only 10% of the cash-flow rights, and Class B shares with 49% of the votes but 90% of the cash-flow rights. The manager-agents would own the Class A shares, and the investor-principals would own the Class B shares. See, e.g., Gordon, supra note 120, at 4.

179 See Wong, supra note 79. Google and Facebook are unusual dual-class firms in that their managers hold only a small share of the cash-flow rights. See Dan Bigman, Facebook Ownership Structure Should Scare Investors More than Botched IPO, Forbes (May 23, 2012, 5:40 PM), http://www.forbes.com/sites/danbigman/2012/05/23/facebookownership-structure-should-scare-investors-more-than-botched-ipo/ (on file with the Columbia Law Review) (noting Facebook founder Mark Zuckerberg "owns about 18% of the company, but controls more than 50% of the voting power" and Google founders Sergey Brin and Larry Page, as of 2012, hold only 21.5% of the "economic share of the company but exercise 73% of the voting power"); see also Steven Davidoff Solomon, New Share Class Gives Google Tighter Control, N.Y. Times: Deal-

holders of such firms cannot interfere with business decisions or replace the board.[180] And while they can sell their shares, the outside shareholders cannot withdraw their investments from the firm.[181] For these reasons, neither activist hedge funds nor hostile raiders can force the managers of a dual-class firm to change their business strategy.[182]

In the absence of direct control mechanisms, investors in dual-class firms discourage self-seeking managerial conduct by giving the managers a large share of the cash flows, typically about 40%.[183] Still, because the managers directly internalize less than half of the costs and benefits of their actions on the firm's behalf, potential agent costs are high.[184] 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 when they are actually performing well.[185] The use

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book (Apr. 13, 2012, 9:17 AM), http://dealbook.nytimes.com/2012/04/13/new-share-class-gives-google-founders-tighter-control/ (on file with the Columbia Law Review) [hereinafter Solomon, New Share Class] (noting that the proposed plan to issue a third class of shares would ensure Google's founders' continuing control while diluting their economic stake).

180 Cf. Bigman, supra note 179 (describing controlling shareholders as "bulletproof").

181 Sales of a firm's shares in the secondary market do not reduce the firm's capital; they merely shift equity from some investors to others. By contrast, the withdrawal of capital by an investor shrinks the pool of assets under management's control. See Henry Hansmann & Reinier Kraakman, The Essential Role of Organizational Law, 110 Yale L.J. 387, 393–98 (2000).

182 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).

183 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, 1084 (2010) [hereinafter Gompers et al., Extreme Governance].

184 See, e.g., Ronald W. Masulis, Cong Wang & Fei Xie, Agency Problems at Dual-Class Companies, 64 J. Fin. 1697, 1698 (2009) ("[S]hareholders anticipate that corporate cash holdings are more likely to be misused at companies where insider voting rights are disproportionately greater than cash flow rights ... .").

185 See, e.g., Goshen & Hamdani, supra note 14, at 591 (exploring the benefits of protecting managers' "idiosyncratic vision"); Bel.n Villalonga & Raphael Amit, Family Control of Firms and Industries, 59 Fin. Mgmt. 863, 901 (2010) ("[F]ounding families retain control when doing so

of a dual-class share structure is a good illustration of the firm-specific nature of corporate governance, as the structure may be well-suited to firms in complex industries such as information technology (e.g., Google,[186] Facebook,[187] and LinkedIn[188]), or to firms whose outside shareholders recognize management's unique skills and strategic vision (e.g., Berkshire Hathaway[189]). It is nonetheless an extreme option on the governance-structure menu, and it is uncommon among public firms in the United States.[190]

III.D.2. The Concentrated-Ownership Structure.

In a firm with concentrated ownership, a single entity (or bloc of investors) controls the corporation by virtue of owning a large number of common shares.[191] But there is no division between control rights and cash-flow rights: The controller owns equal portions of both.[192] Thus, unlike the dual-class share structure, the concentrated-

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gives the firm a competitive advantage ... . The implication is that nonfamily shareholders in those firms are better off than they would be without family control.").

186 See Bigman, supra note 179.

187 See id.

188 See Steven Davidoff Solomon, A Deeper Look at LinkedIn's Structure, N.Y. Times: Dealbook (May 12, 2011, 4:01 PM), http://dealbook.nytimes.com/2011/05/12/adeeper-look-at-linkedins-structure/ (on file with the Columbia Law Review).

189 See Alistair Barr, Buffett Defends Newspapers' Dual-Class Shares, MarketWatch (May 5, 2007, 5:15 PM), http://www.marketwatch.com/story/buffett-defends-dual-classshares-for-newspapers [http://perma.cc/L5TH-KA8L].

190 See Robert Daines & Michael Klausner, Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs, 17 J.L. Econ. & Org. 83, 95 (2001) (finding that only 6% of IPO firms comprising a study's sample had dual-class shares); Gompers et al., Extreme Governance, supra note 183, at 1057 (noting that only about 6% of publicly traded firms in the United States have a dual-class share structure).

191 See, e.g., Goshen & Hamdani, supra note 14, at 564 n. 9.

192 Id. at 591–92 ("Unlike in the dual-class structure, equity in a concentrated-ownership structure is issued at a ratio of one share to one vote.").

ownership structure adheres to the principle of one share, one vote.[193] Control is not contestable unless the controller holds fewer than 50% of the shares.[194] The controller acts as an agent of minority investors and can directly manage the corporation or appoint professional managers whom it can replace at will.[195]

When an agent's control is incontestable, potential principal costs are low but potential agent costs are high. The dual-class share 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 in the concentrated-ownership structure because the controller 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 noted, usually own about 40%).[196] It is probably for this reason that the concentrated-ownership structure is more common.[197] But the dual-class share structure does have one relative advantage: It allows managers to sell a larger slice of the firm's cash flows to outside investors without compromising their complete control.[198] Therefore, if the managers wish to retain incontestable control

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193 Id.; see also Sanford J. Grossman & Oliver D. Hart, One Share-One Vote and the Market for Corporate Control, 20 J. Fin. Econ. 175, 177–78 (1988) (analyzing the conditions for the optimality of the principle of one share, one vote).

194 When a controlling shareholder holds more than 50% of the shares, an acquirer of all other shares obtains only a minority position in the firm.

195 Cf. Gilson, Complicating the Comparative Taxonomy, supra note 85, at 1652 (explaining minority shareholders' interests will be served when benefits from the controlling block's monitoring of management exceed the controlling block's private extraction benefits).

196 See supra notes 183–184, 194 and accompanying text.

197 See Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, Corporate Ownership Around the World, 54 J. Fin. 471, 474 (1999) (finding that concentrated ownership is the dominant structure for large companies worldwide).

198 Interestingly, sometimes even two classes of shares are insufficient to protect control, as Google's creation of a third class of nonvoting shares illustrates. See Tom Hals, Google Settlement Clears Way for New Class C Stock, Reuters (June 17, 2013, 1:44 PM), http://www.reuters.com/article/us-google-stockplan-settlement-idUSBRE95G0MU20130617 [http://perma.cc/GWK9-63MV].

but have limited personal wealth, the dual-class share structure enables them to raise more capital and thereby achieve greater economies of scale. In this way, the choice between the dual-class share structure and the concentrated-ownership structure will often entail a tradeoff between economies of scale and agent costs.

III.D.3. The Dispersed-Ownership Structure.

Notably, the two governance structures discussed so far do not enable outside investors to oust managers.[199] Investors in firms with those structures can sell their interests, but they have little "voice."[200] 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.[201]

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.[202] The structure entrusts managers to make the day-to-day business decisions (normally the CEO's realm of authority[203]) as well as major strategic and

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199 The managers and the controlling shareholder are treated in unity as the agent (i.e., management). See supra text accompanying note 37 (defining the concept of management broadly). Clearly, if the controlling shareholder is not also the manager, then the controlling owner—but not the public shareholders—can replace the manager.

200 Cf. Solomon, New Share Class, supra note 179 (discussing Class A and C shareholders at Google, who have fewer voting rights than Class B shareholders).

201 See, e.g., La Porta et al., supra note 197, at 471.

202 For the seminal article, see Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110, 112–13 (1965) ("[T]he market for corporate control gives to ... shareholders both power and protection commensurate with their interest in corporate affairs.").

203 See Principles of Corp. Governance: Analysis & Recommendations § 3.01 (Am. Law Inst. 1994) (explaining that board-appointed senior executives perform the management duties in public companies).

governance decisions (the board's realm of authority[204]). But shareholders can veto decisions by the board to merge the firm, sell all of its assets, or dissolve it,[205] and they can alter the business plan by replacing the directors.[206] The structure therefore entails lower potential agent costs and higher potential principal costs than does either the dual-class share structure or the concentrated-ownership structure.

A shareholder who wishes to change the business plan 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.[207] Then, to build that stake into a majority of shares, they make a tender offer that offers the other shareholders a premium over the market price.[208] 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.[209] Alternatively, the raider can decide that the incumbent managers' business vision is fundamentally sound, in which case the raider can leave the managers in place and reap the profits from the course they were already pursing.

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204 See Del. Code Ann. tit. 8, § 141(a) (2016) (establishing expansive board authority as the default rule); Principles of Corp. Governance: Analysis & Recommendations § 3.02.

205 See tit. 8 §§ 251, 271, 275 (requiring majority shareholder approval of board resolutions to merge a corporation or sell substantially all of its assets).

206 This is the essential leverage of hedge fund activism. See, e.g., Kahan & Rock, Hedge Funds, supra note 61, at 1029–30 (highlighting the resignation of former Star Gas CEO due to pressure from Third Point Capital).

207 See Ronald J. Gilson, Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense, 35 Stan. L. Rev. 51, 53 (1982) (considering strategies "to exploit the investment in information").

208 Id.

209 See id. (noting that part of the takeover strategy is "to identify a target whose value can be increased by displacing inefficient management").

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.[210] Like raiders, activist funds typically begin a control contest by acquiring a toehold stake through the stock market.[211] 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.[212]

The possibility that a raider or activist fund will contest control of a firm keeps agent costs in check.[213] But because raiders and activists sometimes mistakenly target firms whose managers are in fact competent and loyal,[214] the dispersed-ownership structure – which makes control contests possible – also entails significant principal costs.

Agency-cost theory suggests that governance structures should be arranged vertically, according to their quality, with the structure that minimizes agent conflict costs (direct democracy) on top 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.

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210 See Kahan & Rock, Hedge Funds, supra note 61, at 1088–89 (noting that hedge funds "usually seek only minority representation on the board" and "need the support of others").

211 See, e.g., Gilson & Gordon, supra note 61, at 900.

212 Id.

213 See infra section IV.A.3 (discussing hostile takeovers).

214 See Coffee & Palia, supra note 175, at 583 (noting that target companies often have lower Tobin's Q scores and less "value orientation" but arguing that these metrics are not necessarily "proof of poor managerial performance or high agency costs").

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

Not only does principal-cost theory provide a more compelling explanation for the range of governance structures that firms adopt, but its more comprehensive account of the considerations that shape those structures also yields better empirical predictions and wiser policy prescriptions. The theory's potential implications are numerous; the discussion below addresses implications for several prominent current controversies.

IV.A. Empirical Predictions.

Agency-cost essentialism predicts that, because some governance structures are inherently superior to others, firms that adopt certain structures will consistently generate higher financial returns.[215] The superior structures are those that most empowers shareholders to exercise control and hold managers accountable.[216] If a firm adopts a structure that falls short of this ideal, only two explanations are possible. The first involves a kind of deception: Managers have duped investors into funding a firm with a governance feature that, by enabling managers to sacrifice firm value to their private interests, will provide the investors with inferior returns.[217] The alternative explanation is that the managers have bargained for a structure that indulges

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215 See infra text accompanying notes 226, 231 (describing agency-cost-essentialist predictions in the context of the division of cash flows and dual-class share structures).

216 See infra text accompanying note 236 (discussing such a structural feature—the hostile takeover).

217 See Lucian A. Bebchuk, Letting Shareholders Set the Rules, 119 Harv. L. Rev. 1784, 1789–91 (2006) (arguing that markets do not impose constraints on management and that shareholders rather than managers bear the costs when firms go public with suboptimal governance structures).

the managers' exceptional fondness for control, for which the managers were willing to give up monetary compensation.

Principal-cost theory makes different predictions. It states that a firm's governance structure is irrelevant unless firm-specific elements are taken into account. If firms were identical and the parties who owned and managed them were interchangeable, then any reallocation of control rights between investors and managers would increase one type of cost and decrease the other type by equal amounts. Since total control costs would not change, the degree of delegation – and hence the governance structure – would be irrelevant. It is only when firms have different attributes that differences in governance structures matter, as each firm aims at finding its optimal structure. Moreover, 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 financial returns and particular structural features. If such a correlation is found, then two explanations are possible. One is that firm-specific attributes, not the particular structural feature, explain the difference in value. Once studies properly control for those attributes, the correlation will disappear. The second possible explanation is that an exogenous shock in the legal, economic, or financial environment has thrown off the balance between principal costs and agent costs, leaving a number of firms with governance structures that no longer suit their attributes. After such a shock, firms will require time to adapt their structures to the changed environment. Any correlation between governance structure and firm value will thus be temporary, which studies of the firms' performance over time will confirm.

It is important to note that principal-cost theory does *not* predict that, even in the absence of exogenous shocks, every firm will always have its ideal governance structure. In other words, the theory is not built upon an assumption that markets are perfectly efficient. At any given moment, and even in the absence of large-scale, exogenous shocks, some firms may have structures that delegate too much

control to managers, while others may have structures that delegate too little. Such structural misfits will be the natural result of transaction costs and of the uncertainty that a firm's organizers inevitably face. Those who structure a firm can only make educated guesses about its future operations, personnel, and other attributes. As the future unfolds and contingencies become certainties, the firm's optimal structure may prove to differ from its selected structure. The firm can then try to make a midcourse correction, but transaction costs and other factors may impede the adaptation process, during which structure-based underperformance will persist.

Such structural gaps will, however, be distributed *randomly*, meaning that they should yield no long-term, discernable correlation between firm value and particular governance features. In other words, when a gap opens between a firm's optimal governance structure and its selected structure, the resulting loss of firm value is just as likely to result from excessive principal costs (reflecting inadequate delegation to managers) as from excessive agent costs (reflecting overdelegation to managers). A random distribution of errors will occur because agent costs and principal costs are both foreseeable to firm organizers, and there is no reason that organizers should systematically underestimate the future magnitude of one type of cost relative to the other, especially when they internalize the costs of selecting a suboptimal structure. Agency-cost essentialism implicitly assumes, by contrast, that firm organizers consistently over-empower managers, meaning that they systematically underestimate agent costs or overestimate principal costs.[218]

The two theories also offer different predictions about what will happen to firms when legal reform imposes a particular structural feature. Agency-cost essentialism suggests that such reform will increase average firm value if the mandatory feature empowers shareholders but decrease average firm value if it disempowers them.[219]

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218 See supra text accompanying notes 70–71.

219 See infra sections IV.A.5–.6 (discussing how majority voting and proxy access can reduce agent costs).

Principal-cost theory predicts that such reform will always cause an initial drop in average 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 abate over time, as firms can mitigate the impact of a mandatory rule by altering other structural features, their capital structures, and attributes such as their choice of business strategy.[220] By contrast, scholars who focus on agency costs usually take a static view: If a change in the law disempowers shareholders, the resulting loss of firm value will be permanent in magnitude.[221]

To be sure, the ability of firms to adapt to governance-structure mandates does not mean that the mandates are costless. The process of updating a governance structure requires firms to incur transaction costs that vary depending on whether the necessary adjustment entails, for example, the adoption of a new bylaw (which a board of directors can typically accomplish by resolution), a charter amendment (which requires both a board resolution and a shareholder vote), a change in capital structure or dividend policy, a change in business strategy, a going-private transaction or other change in the identity of investors, or a change in management. Such adaptations can entail significant delay, during which the loss of firm value attributable to the mandate will continue. Finally, the axes along which firms can adjust may only permit a partial correction, leaving a residual loss of firm value that persists indefinitely. In short, principal-cost theory predicts that firms can adjust their control structures and other attributes to *mitigate* the cost of a structural mandate; it does not predict that firms can eliminate the costs of a mandate altogether.

A final difference in predictions pertains to legal reform that permits, but does not require, firms to adopt a new structural feature.

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220 See infra notes 262–266 and accompanying text (describing a pair of studies that found that companies subject to a Massachusetts law requiring staggered boards initially lost value but rebounded due to their adoption of business strategies focused on research and development).

221 Cf. infra notes 298–301 and accompanying text (noting rules favored by agency-cost essentialists for shifting control to shareholders).

If the new option enables firms to disempower shareholders, agency-cost essentialism suggests that self-interested managers will cause their firms to adopt it, driving down average firm value.[222] 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.[223] 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 ignore it, while firms that would benefit will adopt it, exploiting the opportunity to decrease control costs by better tailoring their governance structures to their particular attributes.

With these general predictions in mind, we consider now several topics in corporate governance that empiricists have studied. As the reader will note, for each of the topics surveyed, the empirical literature offers conflicting findings. The inconclusive nature of the empirical studies contradicts agency-cost essentialism, which predicts that shareholder-empowering governance features will always outperform their alternatives.[224] But conflicting findings make sense within the principal-cost framework when studies differ in the degree to which they control for firm-specific characteristics and for firms' capacities to adjust their structures over time based on changes in internal factors and the external environment.

For each topic, we consider whether the empirical results favor agency-cost essentialism or principal-cost theory. Given the numerous studies in the corporate-governance literature from the last

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222 See supra text accompanying notes 45–46.

223 Or at least the default should be an opt-out provision. See, e.g., Lucian Arye Bebchuk & Assaf Hamdani, Optimal Defaults for Corporate Law Evolution, 96 Nw. U. L. Rev. 489, 492–93 (2002) (advocating default rules that restrict management on grounds that "relatively little will be lost because both shareholders and managers will support a charter amendment opting out of [the] inefficient arrangement").

224 See supra notes 70–71 and accompanying text.

forty years, during which agency costs have been the focus, our survey is necessarily abridged. We nonetheless believe it is fair to say that the trends in the empirical literature favor the predictions of principal-cost theory.

IV.A.1. The Division of Cash Flows.

According to the Jensen-Meckling model, allocating more of a firm's cash flows to investors increases agency costs by widening the divide between ownership from control.[225] Based on this observation, some scholars have predicted that firms in which management receives a larger proportion of the cash flows will have higher values.[226] Interestingly, the Jensen-Meckling model itself contradicts this prediction, as it depicts a tradeoff between managerial private benefits and economies of scale, and it predicts that each firm will strike its own, optimal tradeoff.[227] Principal-cost theory yields the same prediction, but for a different reason. Granting a larger proportion of the cash

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225 See Jensen & Meckling, supra note 2, at 309.

226 See, e.g., Benjamin E. Hermalin & Michael S. Weisbach, The Effects of Board Composition and Direct Incentives on Firm Performance, 20 Fin. Mgmt. 101, 111 (1991) (finding that corporate performance increases when management ownership rises to 1% but decreases at higher levels, possibly due to increasing insulation from disciplinary devices that more than offsets the increased alignment of interests between managers and shareholders); Clifford G. Holderness, Randall S. Kroszner & Dennis P. Sheehan, Were the Good Old Days that Good? Changes in Managerial Stock Ownership Since the Great Depression, 54 J. Fin. 435, 466 (1999) (finding that managerial ownership nonlinearly increases and then decreases in firm volatility); John J. McConnell & Henri Servaes, Additional Evidence on Equity Ownership and Corporate Value, 27 J. Fin. Econ. 595, 604 (1990) (finding that the "ownership structure of equity has an important influence on corporate value"); Randall Morck, Andrei Shleifer & Robert W. Vishny, Management Ownership and Market Valuation, 20 J. Fin. Econ. 293, 311 (1988) (finding that as board ownership rises, firm value initially increases, then falls, and finally rises slowly again).

227 See Jensen & Meckling, supra note 2, at 352 ("[F]orces exist to determine an equilibrium distribution of outside ownership. If the costs of reducing the dispersion of ownership are lower than the benefits ... from reducing the agency costs, it will pay some individual or group of individuals to buy shares ... to reduce the dispersion of ownership.").

flows to managers reduces agent conflict costs but increases principal conflict costs. Given this tradeoff, firms will tailor the division of cash flows 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 value varies depending on changes in management's share of ownership; from this, the studies' authors have concluded that some arrangements are superior to others.[228] 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.[229]

IV.A.2. Dual-Class Shares.

Relative to the dispersed-ownership structure, the dual-class share structure gives more power to management, making it harder for outside shareholders to hold managers accountable.[230] Accordingly, many scholars predict that firms with dual-class shares will perform poorly.[231] Taken as a whole, however, the empirical studies do

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228 See supra note 226.

229 See Harold Demsetz & Belén Villalonga, Ownership Structure and Corporate Performance, 7 J. Corp. Fin. 209, 211 (2001) (supporting "the belief that ownership structure is endogenous but not the belief that ownership structure affects firm performance"); Demsetz & Lehn, supra note 31, at 1176 (finding that "the structure of corporate ownership varies systematically in ways that are consistent with value maximization"); Charles P. Himmelberg, R. Glenn Hubbard & Darius Palia, Understanding the Determinants of Managerial Ownership and the Link Between Ownership and Performance, 53 J. Fin. Econ. 353, 381 (1999) (finding that "it becomes difficult to conclude that changes in firm managerial ownership affect performance" when "firm characteristics and firm fixed effects" are controlled).

230 As mentioned earlier, the management and the controlling shareholder are treated as a unity, as the controlling shareholder can replace management. See supra text accompanying note 199.

231 See, e.g., Bebchuk et al., Stock Pyramids, supra note 8, at 310–11 ("[T]he agency costs

not support this claim.[232] While some studies have linked the dual-class share structure to lower firm value,[233] others have found no correlation once firm-specific attributes are taken into account,[234] as principal-cost theory predicts. In addition, studies have found that firms that switch from dispersed ownership to dual-class shares experience an increase in value, a result that principal-cost theory can explain but agency-cost essentialism cannot.[235]

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associated with [controlling-minority-structure] firms increase very rapidly as the fraction of equity cash-flow rights held by controllers declines.").

232 See Renée Adams & Daniel Ferreira, One Share-One Vote: The Empirical Evidence, 12 Rev. Fin. 51, 84 (2008) (surveying the empirical literature on dual-class share structures and concluding that "the findings ... on ownership disproportionality often disagree" and that "simple conclusions may not be possible [because] [o]wnership disproportionality may destroy the value of outside equity in some contexts, but not in others").

233 See, e.g., Gompers et al., Extreme Governance, supra note 183, at 1051 (finding that in "single-stage regressions ... strong evidence [exists] 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"); Masulis et al., supra note 184, at 1697 (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"); Scott B. Smart, Ramabhadran S. Thirumalai & Chad J. 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, 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").

234 See, e.g., Renée B. Adams & João A.C. Santos, Identifying the Effect of Managerial Control on Firm Performance, 41 J. Acct. & Econ. 55, 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."); Ekkehart Böhmer, Gary C. Sanger & Sanjay Varshney, The Effect of Consolidated Control on Firm Performance: The Case of Dual-Class IPOs, in Empirical Issues in Raising Equity Capital 95, 95 (Mario Levis ed., 1996) (finding that. dual-class IPOs "outperform ... matched single-class counterparts in ... returns" and "accounting measures of firm performance" and concluding that "going public with a dual-class equity structure has net benefits for investors"); M. Megan Partch, The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth, 18 J. Fin. Econ. 313, 313 (1987) ("There is no evidence that current shareholders are harmed by the creation of limited voting common stock.").

235 See, e.g., Kenneth Lehn, Jeffry Netter & Annette Poulsen, Consolidating Corporate Control: Dual-Class Recapitalizations Versus Leveraged Buyouts, 27 J. Fin. Econ. 557, 557 (1990) (finding

IV.A.3. Takeover Defenses.

Numerous prominent scholars have voiced support for hostile takeovers as a device for disciplining managers.[236] The stronger version of this position is that boards should be completely passive when threatened by a raider, with no recourse to defensive measures.[237] A more moderate view allows defensive measures, but only if used to facilitate an auction of the target.[238]

Principal-cost theory implies that hostile raiders can generate costs as well as benefits. By using a tender offer to aggregate shareholder control in the hands of a single individual, a raider 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

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that dual-class recapitalizing firms grow faster than firms in a control group, and concluding that "[t]hese results ... illustrat[e] that the method and effects of consolidating corporate control are systematically related to firm attributes"); Valentin Dimitrov & Prem C. Jain, Recapitalization of One Class of Common Stock into Dual-Class: Growth and Long-Run Stock Returns 1 (Sept. 1, 2004) (unpublished manuscript), http://ssrn.com/abstract=422080 (on file with the Columbia Law Review) (finding that "dual-class recapitalizations are shareholder value enhancing corporate initiatives" and that "stockholders, on average, earn significant positive abnormal returns" following the announcement of the recapitalization, and finding no "evidence of managerial entrenchment").

236 The leading voice is Professor Henry Manne. See Henry G. Manne, Cash Tender Offers for Shares—A Reply to Chairman Cohen, 1967 Duke L.J. 231, 236–37 (observing that the threat of raiders encourages managers to manage their companies as efficiently as possible); see also Bebchuk, Undistorted Choice, supra note 120, at 1765–68 (noting that acquisitions may "produce efficiency gains by ... improving management"); Easterbrook & Fischel, The Proper Role, supra note 57, at 1169 (noting that a tender offer "polices managers" and "disciplines or replaces them if they stray too far from the service of the shareholders"); Gilson, Structural Approach, supra note 57, at 844 (observing that the tender offer is the "only displacement mechanism" with the potential to constrain management self-dealing).

237 See Easterbrook & Fischel, The Proper Role, supra note 57, at 1194–204 (advocating antiresistance provisions that would prevent management from defeating tender offers).

238 See Gilson, Structural Approach, supra note 57, at 875–81 (suggesting a rule permitting management actions that facilitate shareholder decisionmaking and prohibiting management actions that interfere with shareholder decisions on tender offers).

of the incumbent managers' strategy, they could tender at an inadequate price, thus giving away the firm's hidden value.[239] The anticipation of such value transfers from public shareholders to raiders may generate principal competence costs by raising firms' cost of equity capital. Similarly, groups of shareholders who would tender their shares because they prefer short-term profits at the expense of long-term returns might generate principal conflict costs by inducing the firm's managers to take expensive self-protective measures.[240] Permitting hostile takeovers could thus increase or decrease overall control costs, with the effect varying by firm based on factors such as the personal characteristics of its managers and shareholders, and its industry and competitive environment.[241] For firms whose management is untrustworthy and whose business is easy for shareholders to understand, allocating control over takeovers to shareholders could reduce total control costs. But for firms whose management is trustworthy and whose business is difficult for shareholders to understand, allocating control to boards could 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.[242] To circumvent a pill, a raider must take control of the target's board through a proxy fight, which requires time and

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239 But see Bernard Black & Reinier Kraakman, Delaware's Takeover Law: The Uncertain Search for Hidden Value, 96 Nw. U. L. Rev. 521, 528–34 (2002) (rejecting the claim of hidden value).

240 See Brian J. Bushee, The Influence of Institutional Investors on Myopic R&D Investment Behavior, 73 Acct. Rev. 305, 305 (1998) (arguing that a high level of institutional ownership by institutions exhibiting high portfolio turnover, diversification, and momentum trading significantly increases managerial incentives to pursue short-term projects).

241 See F.M. Scherer, Corporate Takeovers: The Efficiency Arguments, 2 J. Econ. Persp. 69, 74–76 (1988) (interpreting an empirical study that used a line-of-business approach to conclude that takeovers do not have uniform effects on targets' long-term value).

242 See Suzanne S. Dawson, Robert J. Pence & David S. Stone, Poison Pill Defensive Measures, 42 Bus. Law. 423, 426–32 (1987).

money.[243] The pill thus increases board power relative to shareholder power, leading some scholars to condemn it as an entrenchment device that increases agency costs and thus reduces firm value.[244] But a pill can also reduce principal costs. Forcing raiders to wage proxy fights can reduce collective-action problems among shareholders,[245] and the pill's capacity to encourage competing bids reduces the risk that shareholders will tender at an inadequate price.[246] Once again, the net effect on control costs will depend on the specific firm.[247] 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, only one third, rather than the full slate, of whose members stands for election each year.[248] The practical consequence of a staggered board is that a raider must win proxy fights at two consecutive annual shareholder meetings to obtain control of the company.[249] Proponents ar-

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243 See 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, 913 (2002) [hereinafter Kahan & Rock, Adaptive Responses] ("To overcome a pill, a hostile raider must replace the board in a proxy contest. In a company with a staggered board, this takes over a year ... .").

244 See, e.g., Lucian Arye Bebchuk, The Case Against Board Veto in Corporate Takeovers, 69 U. Chi. L. Rev. 973, 991–94 (2002) (examining the agency costs of poison pills).

245 Kahan & Rock, Adaptive Responses, supra note 243, at 903.

246 See Randall A. Heron & Erik Lie, On the Use of Poison Pills and Defensive Payouts by Takeover Targets, 79 J. Bus. 1783, 1801–03 (2006) (presenting evidence that poison pills increase bids and deal premiums).

247 See Heron & Lie, supra note 246, at 1794 (noting that responses to unsolicited takeovers differ based on a host of factors, including "the consequence ... for incumbent management, the premium offered to shareholders, management's assessment of firm value, and the target's bargaining power"). That firms do not have a uniform response to poison pills is reflected in the conflicting empirical work on the subject. Compare Michael Ryngaert, The Effect of Poison Pill Securities on Shareholder Wealth, 20 J. Fin. Econ. 377, 386–411 (1988) (concluding from empirical evidence that poison pills do not, on average, benefit shareholders), with Heron & Lie, supra note 246, at 1801–03 (presenting empirical evidence that poison pills increase bids and premiums).

248 See Del. Code Ann. tit. 8, § 141(d) (2016).

gue that a staggered board provides stability and permits greater continuity in strategic planning.[250] But scholars who focus on agency costs harshly criticize the staggered board as an entrenchment mechanism that, when combined with a pill, makes a firm essentially impervious to raids.[251] Their campaign against the staggered board has been effective: Over the past decade, Professor Lucian Bebchuk and Harvard Law School's Shareholder Rights Project have persuaded the boards of approximately one-third of all S&P 500 companies to destagger.[252] Before this campaign, the majority of S&P 500 companies had staggered boards; now, most do not.[253]

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 their firm's hidden value and thus might tender to a raider at an inadequate price. Fearing such mistakes, boards might 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 multiyear strategies.[254] As with poison pills,

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249 Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 114–15 (Del. Ch. 2011) (noting that the Delaware Supreme Court's opinion in Versata Enters. v. Selectica, 5 A.3d 586 (Del. 2010), observed that raiders can take control of staggered boards if willing to wait two years).

250 See, e.g., Lipton, supra note 175.

251 Bebchuk et al., Force of Staggered Boards, supra note 7, at 904–08 (explaining that for firms with staggered boards, the poison pill provides an "impenetrable barrier to control acquisitions").

252 See Lucian Bebchuk, Scott Hirst & June Rhee, Towards the Declassification of S&P 500 Boards, 3 Harv. Bus. L. Rev. 157, 171 & tbl.6 (2013); Steven Davidoff Solomon, The Case Against Staggered Boards, N.Y. Times: Dealbook (Mar. 20, 2012, 12:43 PM), http://dealbook.nytimes.com/2012/03/20/the-case-against-staggered-boards (on file with the Columbia Law Review) [hereinafter Solomon, The Case] (describing Bebchuk's campaign).

253 See Solomon, The Case, supra note 252 (noting that "302 S&P 500 companies had staggered boards in 2002" but by 2012 "the figure ha[d] fallen to 126").

254 See Lipton, supra note 175.

some firms will benefit from staggered boards, while others will not.[255]

Empirical studies of takeover defenses have yielded mixed results.[256] While several studies have found that antitakeover devices reduce firm value,[257] others have identified flaws in these studies,[258] and a third set of studies has found that firms with certain attributes can increase their value by adopting antitakeover devices,[259] as principal-cost theory predicts. Similarly conflicting results are seen in studies that seek to link staggered boards to reduced firm value: Some find such a link,[260] but others that control for firm-specific characteristics find no such connection.[261]

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255 See K.J. Martijn Cremers, Lubomir P. Litov & Simone M. Sepe, Staggered Boards and Long-Term Firm Value, Revisited 9–25 (Nov. 2016) (unpublished manuscript), http://ssrn.com/abstract=2364165 (on file with the Columbia Law Review) (finding that the effect of a staggered board on firm value differs depending on the characteristics of the firm).

256 See Miroslava Straska & H. Gregory Waller, Antitakeover Provisions and Shareholder Wealth: A Survey of the Literature, 49 J. Fin. & Quantitative Analysis 933, 950 (2014) (reviewing forty years of studies and concluding that "[d]espite 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").

257 See, e.g., Paul H. Malatesta & Ralph A. Walkling, Poison Pill Securities: Stockholder Wealth, Profitability, and Ownership Structure, 20 J. Fin. Econ. 347, 362–63 (1988) (concluding from statistical analysis that "the adoption of poison pill defenses reduces stockholder wealth").

258 Emiliano M. Catan & Marcel Kahan, The Law and Finance of Antitakeover Statutes, 68 Stan. L. Rev. 629, 650–64 (2016); John C. Coates IV, Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence, 79 Tex. L. Rev. 271, 280–86 (2000).

259 See, e.g., Dalida Kadyrzhanova & Matthew Rhodes-Kropf, Concentrating on Governance, 66 J. Fin. 1649, 1654–82 (2011) (developing a model to predict which corporate governance tradeoffs firms should adopt based on their characteristics); Scott C. Linn & John J. McConnell, An Empirical Investigation of the Impact of 'Antitakeover' Amendments on Common Stock Prices, 11 J. Fin. Econ. 361, 397 (1983) (finding, after empirical analysis, that antitakeover amendments are associated with an "increase in common stock prices and that the removal of antitakeover amendments is associated with a decline in stock prices"); see also Straska & Waller, supra note 256, at 938–40 (finding that firm value increases in antitakeover indexes for firms with low bargaining power).

260 See, e.g., Lucian A. Bebchuk & Alma Cohen, The Costs of Entrenched Boards, 78 J. Fin. Econ. 409, 419–26 (2005).

Perhaps the best illustration of the predictive power of principal-cost theory on this topic is a pair of studies of a 1990 Massachusetts law that required all public firms incorporated in that state to have staggered boards.[262] An event study by Professor Robert Daines found that the law reduced shareholder wealth.[263] This finding is consistent with agency-cost essentialism, which suggests that staggered boards are *always* value-decreasing; it also is consistent with principal-cost theory, which holds that a mandatory structural feature harms firms whose cost-minimizing governance structure does not include that feature.[264] However, in a recent study, Daines and two coauthors revisited the Massachusetts firms fifteen years later and found that those with specific attributes – namely, a high degree of innovation and investment in research and development – had rebounded in value.[265] The authors concluded that staggered boards can benefit firms with certain attributes.[266] This result is consistent with principal-cost theory, which predicts that firms will respond to

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261 See, e.g., Thomas W. Bates, David A. Becher & Michael L. Lemmon, Board Classification and Managerial Entrenchment: Evidence from the Market for Corporate Control, 87 J. Fin. Econ. 656, 658 (2008) (finding that "the evidence is inconsistent with the view that board classification is associated with managerial entrenchment and instead suggests that classification improves the relative bargaining power of target managers on behalf of their constituent shareholders").

262 See Robert Daines, Shelley Xin Li & Charles C.Y. Wang, Can Staggered Boards Improve Value? Evidence from the Massachusetts Natural Experiment 4 (Stanford Law Sch. John M. Olin Program in Law & Econ., Paper No. 498, 2016) [hereinafter Daines et al., Can Staggered Boards Improve Value], http://ssrn.com/abstract=2836463 (on file with the Columbia Law Review) (reporting on the value of impacted firms eleven years after an initial study); Robert M. Daines, Do Classified Boards Affect Firm Value? Takeover Defenses After the Poison Pill 27 (unpublished manuscript) (on file with the Columbia Law Review) [hereinafter Daines, Classified Boards] (providing "evidence of investors' reaction to a 1990 Massachusetts law ... that imposed [staggered] boards on its public firms").

263 Daines, Classified Boards, supra note 262, at 27–28.

264 See supra text accompanying notes 222–223.

265 Daines et al., Can Staggered Boards Improve Value, supra note 262, at 4.

266 Id. at 4–5, 27 (finding that staggered boards can be beneficial when firms and investors face information asymmetries, which is especially likely when firms are young, innovative, or reliant on research and development).

external legal shocks by adjusting other structural features as well as attributes such as their business strategies.

IV.A.4. Hedge Fund Activism.

Scholars whose primary concern is agency costs strongly support activist hedge funds,[267] whose business model is to challenge incumbent directors of public companies through publicity campaigns and proxy fights.[268] Such challenges overcome shareholders' rational apathy and institutional investors' rational reticence, increasing the power of shareholder voting rights and thus reducing agent costs.[269] For example, an activist fund might force empire-building managers to reduce inefficient capital expenditures.[270] Yet activist funds can also generate principal costs, a downside that their academic supporters dismiss. 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.[271] 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.[272] All studies show that firms experience an initial spike

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267 See, e.g., Bebchuk et al., Long-Term, supra note 63, at 1087–89 (presenting evidence refuting the claim that shareholder activism reduces long-term firm value).

268 See Kahan & Rock, Hedge Funds, supra note 61, at 1029.

269 See Gilson & Gordon, supra note 61, at 897–98 (noting that the interaction

270 See Bebchuk et al., Long-Term, supra note 63, at 1136 (arguing that shareholder activism can combat "management's tendency to avoid distributing excess cash or assets to shareholders").

271 See Coffee & Palia, supra note 175, at 41–49 (describing the activist hedge fund practice of slashing research and development in pharmaceutical industry targets).

272 See id. at 49–64 (reviewing and analyzing the empirical studies).

in share price when the market learns that they have been targeted.[273] But the long-term impact on share price is unclear: Some studies have found that activism improves long-term performance,[274] but others have found flaws in these studies.[275] A third set of studies has found that activism ultimately harms its targets,[276] a result that principal-cost theory can explain but agency-cost essentialism cannot. Furthermore, 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 firm value.[277] 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 on social value.

IV.A.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.[278] The alternative rule is majority voting, under which di-

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273 See, e.g., id. at 64 (concluding "the evidence is clearest that there is a short-term positive stock price reaction to a Schedule 13D's filing").

274 See, e.g., Bebchuk et al., Long-Term, supra note 63, at 1155.

275 See, e.g., Coffee & Palia, supra note 175, at 53.

276 See K.J. Martijn Cremers, Erasmo Giambona, Simone M. Sepe & Ye Wang, Hedge Fund Activism and Long-Term Firm Value 2 (Jan. 2016) (unpublished manuscript), http://ccl.yale.edu/sites/default/files/files/leo16_Sepe.pdf (on file with the Columbia Law Review) (finding that "firms targeted by activist hedge funds improve less in value subsequent to the start of an activist hedge fund campaign than ex-ante similarly poorly performing control firms that are not subject to hedge fund activism").

277 See Coffee & Palia, supra note 175, at 7–8 (noting the paucity of evidence about the marketwide impact of activism).

278 Del. Code Ann. tit. 8, § 216(3) (2016) ("In the absence of such specification in the certificate

rectors who do not receive majority support must resign their seats.[279] Majority voting thus provides a cheap substitute for a proxy fight. Because majority voting increases shareholder power, many scholars view it positively.[280] But an increase in shareholder power raises principal costs and thus could increase total control costs at many firms. Unsurprisingly, studies of majority voting have produced inconclusive results: While one finds a positive effect,[281] others find no impact on shareholder value.[282] Principal-cost theory predicts that, once one controls for firm-specific characteristics, firms with majority voting will not consistently outperform those without it. Studies that do find a directional result probably lack adequate controls or proper samples and therefore are unlikely to be confirmed by subsequent studies.

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of incorporation or bylaws of the corporation ... [d]irectors 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."); see also Joseph A. 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 a symbolic "no").

279 See, e.g., Stephen J. Choi, Jill E. Fisch, Marcel Kahan & Edward B. Rock, Does Majority Voting Improve Board Accountability?, 83 U. Chi. L. Rev. 1119, 1124–28 (2016).

280 See, e.g., Majority Voting for Directors, Council of Institutional Inv'rs, http://www.cii.org/majority_voting_directors [http://perma.cc/RUL3-RME2] (last visited Nov. 2, 2016) ("Majority voting for directors ensures that shareowners' votes have 'teeth', keeping board members responsive to the shareowners they represent.").

281 See Yonca Ertimur, Fabrizio Ferri & David Oesch, Does the Director Election System Matter? Evidence from Majority Voting, 20 Rev. Acct. Stud. 1, 11 (2015) (finding that the adoption of shareholder proposals for majority voting is associated with positive abnormal stock returns).

282 See Jay Cai, Jacqueline L. Garner & Ralph A. Walkling, A Paper Tiger? An Empirical Analysis of Majority Voting, 21 J. Corp. Fin. 119, 120 (2013) (finding that the "adoption of majority voting has little effect on director votes, director turnover, or improvement of firm performance"); Choi et al., supra note 279, at 1122 (finding that "under plurality voting, the likelihood that a director fails to receive a majority 'for' vote is nineteen times higher than under majority voting"); William K. Sjostrom, Jr. & Young Sang Kim, Majority Voting for the Election of Directors, 40 Conn. L. Rev. 459, 489–92 (2007) (finding no statistically significant market reaction to a company's adoption of majority voting).

IV.A.6. Proxy Access.

A proxy fight typically costs the challengers about $6,000,000,[283] and the corporation reimburses the challengers only if they prevail.[284] The consequence is a classic collective-action problem that discourages proxy challenges: Challengers internalize all of the expected costs of a proxy fight but only a fraction of 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 hence the corporation's funds) to seek votes for their own partial slates of director candidates.[285] 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.[286] In this way, it reduces agent costs and hence, according to agency-cost essentialism, increases firm value.[287]

But proxy access also increases principal costs: Although it facilitates the replacement of lazy, incompetent, or disloyal directors, it

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283 See Nickolay Gantchev, The Costs of Shareholder Activism: Evidence from a Sequential Decision Model, 107 J. Fin. Econ. 610, 623 tbl.7, 624 (2013) (finding an average cost of $5.94 million for proxy contests, which includes "printing and postage costs" and "significant disclosure, legal and other fees of hiring proxy solicitors, corporate governance experts, investment banks, public relations and advertising firms").

284 See Recent Developments, Contestants in Proxy Fight Entitled to Reimbursement of Expenses from Corporate Treasury, 56 Colum. L. Rev. 633, 634–35 (1956) (discussing when challengers may be reimbursed and noting the uncertainty of whether "losing insurgents can be reimbursed").

285 See, e.g., Lucian Arye Bebchuk, The Case for Shareholder Access to the Ballot, 59 Bus. Law. 43, 47 (2003) [hereinafter Bebchuk, Shareholder Access] (explaining how the proposal for proxy access "would make it easier for shareholders to elect candidates other than those proposed by incumbent directors"). A typical proxy-access bylaw would allow investors owning 3% to 5% of a company's stock for three or more years to nominate directors for the company's board of directors. See id.

286 See id. at 65 (arguing that empowering shareholders to replace directors through proxy access would "improve[] corporate governance").

287 See id. at 51–53.

also increases the risk that shareholders will mistakenly replace good directors (thus generating principal competence costs) or 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.[288] Whether proxy access will increase[289] or decrease[290] overall firm value is thus difficult to predict ex ante, which the empirical literature confirms.[291]

IV.A.7. The G Index.

Finally, the most famous empirical paper cited in support of agency-cost essentialism is a study of a corporate-governance index, dubbed the G index, which consists of twenty-four governance factors (such as a staggered board) that purportedly reduce managerial

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288 See John G. Matsusaka, Oguzhan Ozbas & Irene Yi, Opportunistic Proposals by Union Shareholders 26 (Univ. of S. Cal. Ctr. for Law & Soc. Sci., Research Paper No. CLASS15-25, 2016), http://ssrn.com/abstract=2666064 (on file with the Columbia Law Review) (finding evidence of unions using "shareholder proposals opportunistically" in negotiations).

289 See, e.g., Bo Becker, Daniel Bergstresser & Guhan Subramanian, Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable's Challenge, 56 J.L. & Econ. 127, 129 (2013) (finding evidence that shareholders value access); Joanna Tochman Campbell, T. Colin Campbell, David G. Sirmon, Leonard Bierman & Christopher S. Tuggle, Shareholder Influence over Director Nomination via Proxy Access: Implications for Agency Conflict and Stakeholder Value, 33 Strategic Mgmt. J. 1431, 1447 (2012) (arguing that "additional value is created when owners are granted greater voice in the firm's governance").

290 See, e.g., Ali C. Akyol, Wei Fen Lim & Patrick Verwijmeren, Shareholders in the Boardroom: Wealth Effects of the SEC's Proposal to Facilitate Director Nominations, 47 J. Fin. & Quantitative Analysis, 1029, 1055 (2012) (presenting evidence that shareholder access decreases firm value); David F. Larcker, Gaizka Ormazabal & Daniel J. Taylor, The Market Reaction to Corporate Governance Regulation, 101 J. Fin. Econ. 431, 433 (2011) (presenting evidence that increased shareholder access lowers firm value).

291 See, e.g., Marcel Kahan & Edward Rock, The Insignificance of Proxy Access, 97 Va. L. Rev. 1347, 1426 (2011) (considering the positive and negative effects of proxy access and concluding that "the net effect of proxy access is likely to be close to zero and surely is not high enough to get very excited about").

accountability.[292] The study assigned each firm an index score equal to the number of such factors it possessed and then regressed the score against firm value. The study found a strong negative relationship between index score and firm value.[293] The study's use of different allocations of control rights – reflected in different G scores – to explain differences in firm value contradicts principal-cost theory's claim that, unless firms vary in their attributes, their choice of governance structure is irrelevant. Although the study's finding appears to support agency-cost essentialism, some academics have criticized the study for methodological flaws and misspecifications.[294] In addition, a follow-up study showed that six factors related to takeover defenses fully explained the correlation identified by the original study.[295] And a more recent study has shown that, depending on firm-specific characteristics, only three of those six factors correlate negatively with firm value, while the other three correlate positively.[296] This trend in

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292 Paul Gompers, Joy Ishii & Andrew Metrick, Corporate Governance and Equity Prices, 118 Q.J. Econ. 107, 114 (2003).

293 Id. at 144–45.

294 See, e.g., Jianxin (Daniel) Chi, Understanding the Endogeneity Between Firm Value and Shareholder Rights, 34 Fin. Mgmt. 65, 66 (2005) (finding that the negative relationship between the G index and Tobin's Q runs from G to Q and not vice versa); 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, 680–81 (2006) (finding that weak shareholder rights are unlikely to cause lower abnormal stock returns and suggesting that market model misspecification may explain the difference in abnormal returns between high and low G-index firms); K.J. Martijn Cremers, Vinay B. Nair & Kose John, Takeovers and the Cross-Section of Returns, 22 Rev. Fin. Stud. 1409, 1432 (2009) (finding that the market model used in the G index was misspecified); Shane A. Johnson, Theodore C. Moorman & Sorin Sorescu, A Reexamination of Corporate Governance and Equity Prices, 22 Rev. Fin. Stud. 4753, 4755 (2009) (finding that the asset-pricing model used in the G index was misspecified); Kenneth Lehn, Sukesh Patro & Mengxin Zhao, Governance Indexes and Valuation: Which Causes Which?, 13 J. Corp. Fin. 907, 908–09 (2007) (finding it unlikely that high G index scores cause lower valuations).

295 See Lucian Bebchuk, Alma Cohen & Allen Ferrell, What Matters in Corporate Governance?, 22 Rev. Fin. Stud. 783, 823 (2009) (identifying "six entrenching provisions" that "fully drive the findings documented by [the] prior research").

296 K.J. Martijn Cremers, Saura Masconale & Simone M. Sepe, Commitment and Entrenchment in Corporate Governance, 110 Nw. U. L. Rev. 727, 733 (2016).

studies of the G index confirms principal-cost theory's prediction that, as such studies become more refined, fewer structural elements will correlate with firm performance.[297]

IV.B. Implications for Lawmakers.

Another important difference between agency-cost essentialism and principal-cost theory is their policy implications. Scholars who tend toward essentialism favor mandatory rules that shift control to shareholders:[298] They would ban dual-class shares,[299] poison pills,[300] and staggered boards[301] while requiring majority voting[302] and

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297 See, e.g., Sanjai Bhagat, Brian Bolton & Roberta Romano, The Promise and Peril of Corporate Governance Indices, 108 Colum. L. Rev. 1803, 1808 (2008) (finding that "there is no consistent relation between the academic and related commercial governance indices and corporate performance"); Tatyana Sokolyk, The Effects of Antitakeover Provisions on Acquisition Targets, 17 J. Corp. Fin. 612, 612 (2011) (finding that while individual antitakeover provisions have significant effects on takeover outcomes, the G Index "is not significant in predicting a firm's risk of being acquired").

298 See, e.g., Lucian Arye Bebchuk, The Debate on Contractual Freedom in Corporate Law, 89 Colum. L. Rev. 1395, 1401 n.32 (1989) (advocating a mandatory rule limiting midstream amendments of corporate charters, as such amendments often transfer value from shareholders to managers); Lucian Arye Bebchuk, Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 Harv. L. Rev. 1820, 1836 (1989) (arguing that mandatory rules should preclude midstream amendments of corporate charters because shareholders lack information to make voting decisions).

299 See Bebchuk et al., Stock Pyramids, supra note 8, at 295 (claiming that dual-class shares produce a radical separation between control rights and cash-flow rights).

300 See, e.g., Lucian A. Bebchuk & Robert J. Jackson, Jr., Toward a Constitutional Review of the Poison Pill, 114 Colum. L. Rev. 1549, 1551 (2014) (arguing that the Williams Act may preempt state laws that authorize the use of the poison pill).

301 See, e.g., Bebchuk et al., Force of Staggered Boards, supra note 7, at 936–39 (arguing that the powerful antitakeover effect of staggered boards harms target shareholders).

302 See, e.g., Lucian A. Bebchuk, The Myth of the Shareholder Franchise, 93 Va. L. Rev. 675, 702 (2007) (arguing that majority voting should be the default rule due to the "clear and widely accepted flaws" of plurality voting).

proxy access.[303] But the inescapable tradeoff between principal costs and agent costs cautions against such one-size-fits-all regulations.[304] It suggests that lawmakers should permit a range of governance structures, enabling each firm to allocate control rights in the manner that minimizes total control costs.

As an illustration, consider the debate over proxy access. Because proxy access reduces agent costs, many scholars would mandate it.[305] Their advocacy found success in 2010 when the SEC announced Rule 14a-11, which would have required proxy access at all public companies.[306] But before the rule could go into effect, the D.C. Circuit Court of Appeals vacated it on grounds that the SEC had failed to conduct an adequate cost-benefit analysis.[307] Shifting tactics, advocates pressed firms to adopt proxy access voluntarily.[308] Buttressing

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303 See, e.g., Bebchuk, Shareholder Access, supra note 285, at 66 (concluding that a well-designed shareholder-access regime would contribute to making directors more accountable and would improve corporate governance).

304 See, e.g., Sridhar Arcot & Valentina Bruno, One Size Does Not Fit All, After All: Evidence from Corporate Governance 1 (Jan. 15, 2007) (unpublished manuscript), http://ssrn.com/abstract=887947 (on file with the Columbia Law Review) (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").

305 See, e.g., Bebchuk & Hirst, supra note 6, at 350 (concluding that some firms whose shareholders favor proxy access will fail to adopt it unless proxy access is made the default rule).

306 See Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,668 (Sept. 16, 2010) (codified at 17 C.F.R. pts. 200, 232, 240 and 249) (announcing changes to the federal proxy-access rules).

307 Bus. Roundtable v. SEC, 647 F.3d 1144, 1148–49 (D.C. Cir. 2011) ("[T]he Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.").

308 See, e.g., Adam Brown, New York City Comptroller Expands Proxy Access Campaign, IR Mag. (Jan. 12, 2016), http://www.irmagazine.com/articles/corporategovernance/21183/new-york-city-comptroller-expands-proxy-access-campaign/ (on file with the Columbia Law Review) (explaining the New York City pension fund system filed seventy-two shareholder resolutions demanding proxy access).

these efforts, the Delaware legislature amended the state's general corporations law to permit proxy-access bylaws[309] and the SEC amended Rule 14a-8 (the town-meeting rule) to allow proxy-access proposals.[310] Consequently, in 2015 over half of all proxy-access proposals submitted under Rule 14a-8 passed,[311] and companies such as General Electric adopted proxy access unilaterally, without a shareholder proposal.[312]

Despite such successes, shareholders are not always receptive to proxy access, and most large companies have not adopted it.[313] Scholars who focus primarily on agency costs blame this continuing resistance on market failure and destructive conflicts of interest among institutional investors.[314] They thus continue to favor mandatory proxy access for all public firms.[315]

Principal-cost theory counsels against mandatory proxy access. Because its impact on control costs depends on firm-specific characteristics,[316] proxy access is likely to benefit some firms but

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309 Del. Code Ann. tit. 8, § 112 (2016).

310 75 Fed. Reg. at 56,730.

311 Holly J. Gregory, Sidley Austin LLP, Hot Topics for the 2016 Proxy Season 33 (2015), http://www.sidley.com/~/media/publications/oct15_governancecounselor.pdf [http://perma.cc/HY6U-8KL3] (reporting that proxy-access proposals had received, on. average, the support of 54.3% of voting shares and had passed at 51 out of 87 companies).

312 Ted Mann & Joann S. Lublin, GE to Allow Proxy Access for Big Investors, Wall St. J. (Feb. 11, 2015, 6:40 PM), http://www.wsj.com/articles/ge-amends-bylaws-to-allow-proxyaccess-for-big-investors-1423698010 (on file with the Columbia Law Review).

313 See Joann S. Lublin, Investors Gain Greater Clout over Boards, Wall St. J. (Jan. 10, 2016, 7:00 PM), http://www.wsj.com/articles/investors-gain-greater-clout-over-boards-1452470402 (on file with the Columbia Law Review) (noting that Institutional Shareholder Services Inc. reported that only 21% of S&P 500 companies adopted proxy access in 2015).

314 See, e.g., Bebchuk & Hirst, supra note 6, at 332.

315 See id.

316 See supra section IV.A.6 (discussing how proxy access reallocates control rights from boards to shareholders and as such will decrease agent costs and increase principal costs, with the overall effect being firm-specific).

harm others. Therefore, lawmakers should respect the shareholders' decision at each firm as to whether 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 believe that proxy access would increase principal costs more than it would decrease agent costs.[317] 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.[318] The lack of substantial market impediments to shareholder-initiated change[319] is also suggested by shareholder-rights advocates' successful campaigns to destagger boards[320] and establish majority voting.[321] 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.[322]

In short, lawmakers should not mandate changes in the allocation of control rights between investors and managers. Instead they should adopt measures that enable parties to craft firm-specific solutions to the many nuances of the perennial principal-agent problem.[323] In particular, lawmakers should transform rules that dictate the

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317 See supra note 311 and accompanying text.

318 See Lublin, supra note 313 (reporting that "American businesses are increasingly bowing to investors' demands for greater boardroom clout, with dozens of companies revising their bylaws" ahead of 2015 annual meetings).

319 See Bebchuk, Shareholder Access, supra note 285, at 45 (describing the "public good" problem with running proxy contests).

320 See supra note 252 and accompanying text (discussing how Professor Bebchuk and Harvard Law School's Shareholder Rights Project persuaded the boards of approximately one-third of all S&P 500 companies to destagger).

321 See Choi et al., supra note 279, at 1124–29.

322 See Gilson & Gordon, supra note 61, at 866–67 (arguing that institutional investors will respond to proposals initiated by activist shareholders).

allocation of control rights into default rules[324] unless there is a specific market failure.[325] 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 minimize total control costs at the majority of firms.[326] 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 governance structures, capital structures, and business strategies to minimize the sum of principal costs and agent costs within the existing legal environment.[327]

Conclusion.

This Essay has introduced the principal-cost theory of corpo-

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323 The claim that corporate law should consist of default rules is a central tenet of the contractarian school. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 6–7 (1996) [hereinafter Easterbrook & Fischel, The Economic Structure]; cf. Hansmann & Kraakman, End of History, supra note 144, at 439–41 (observing that corporate-governance structures throughout the world have converged around a "standard shareholder-oriented model").

324 See, e.g., Stephen M. Bainbridge, Preserving Director Primacy by Managing Shareholder Interventions, in Research Handbook on Shareholder Power and Activism 231, 246 (Jennifer G. Hill & Randall S. Thomas eds., 2015) (arguing that corporations should be permitted to opt out of the SEC's mandatory shareholder proposal rule).

325 Cf. Gabriel Rauterberg & Eric Talley, Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers, 117 Colum. L. Rev. (forthcoming 2017) (on file with the Columbia Law Review) (analyzing the effects of the newly provided option to opt out of the duty of loyalty as it pertains to corporate opportunities); Roberta Romano, Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws, 89 Colum. L. Rev. 1599, 1616–17 (1989) (seeking to limit the role of mandatory corporate law to cases in which externalities are present).

326 See, e.g., Easterbrook & Fischel, The Economic Structure, supra note 323, at 28.

327 See supra notes 265–266 and accompanying text.

rate law and governance. The theory states that a business firm's optimal governance structure minimizes the sum of principal costs and agent costs. Principal costs arise when investors exercise control in a manner that, due to honest mistakes or self-seeking motives, 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 essentialism, the prevailing paradigm in the study of corporate law, cannot. The essentialist view is 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. That theory has difficulty explaining 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). Agency-cost essentialism holds that firms that give less power to shareholders will consistently generate lower financial returns than those that empower shareholders. Yet careful empirical studies refute this claim. Principal-cost theory, by contrast, explains that the governance-structure spectrum reflects the firm-specific nature of the principal-cost/agent-cost tradeoff, and it accurately predicts that firms will be found to generate consistent financial returns across the spectrum once firm-specific characteristics are taken into account.

Principal-cost theory also offers different policy prescriptions. Because agency-cost essentialism holds that corporate governance features that disempower shareholders, such as staggered boards and dual-class shares, destroy firm value, many of its adherents argue that such features should be banned. Principal-cost theory, by contrast,

suggests that lawmakers should avoid one-size-fits-all governance rules and instead allow each firm to tailor its governance structure in the manner that strikes the firm-specific optimal balance between principal costs and agent costs. Because principal-cost theory reframes many of the key debates in corporate governance, the full extent of its predictive and prescriptive implications is a promising subject for future scholarship.