# The Neglected Role of Justification under Uncertainty in Corporate Governance and Finance

Law Working Paper N° 429/2018
January 2019

Claire A. Hill
University of Minnesota

Alessio M. Pacces
University of Amsterdam and ECGI

ECGI Working Paper Series in Law

# The Neglected Role of Justification under Uncertainty in Corporate Governance and Finance

Working Paper N° 429/2018
January 2019

Claire A. Hill
Alessio M. Pacces

We wish to thank Margaret Blair, June Carbone, Douglas Cumming, Eric Hillemann, Jonathan Klick, Joe McCahery, Brett McDonnell, Georg Ringe, Andrew Winton and an anonymous referee for extremely helpful discussions and comments on drafts, and Jeffrey Siwik and particularly, Scott Dewey, for extremely helpful research assistance.

## Abstract

The big corporate governance debates nowadays concern the corporation's time horizons, and the balance of power between shareholders and managers. In response to actual and anticipated pressure from shareholder activists – typically, activist hedge funds – companies are, some say, becoming too short-term. If this story is credited, shareholders, as well as the greater society are being harmed. We argue here that this story may reflect, at least in part, a heretofore neglected facet of decision-making: an actor's accountability, and consequently, her anticipated need to justify her decision in the case of a bad outcome. Our account does three novel things. First, we demonstrate that the need to justify is pervasive. Our account identifies a type of agency cost, "justification costs," resulting from decisions motivated by justification. Under conditions of uncertainty, justification costs are higher. By contrast, in conditions of less uncertainty, the most justifiable decision is apt to be the decision made without regard to justification. Second, to our knowledge, the relationship between these sorts of agency costs and more traditional agency costs, such as those involving self-dealing or empire building, has not been considered. Reducing traditional agency costs typically means increasing accountability and the consequent anticipated need for justification; by contrast, reducing costs of justification generally means increasing managerial leeway, which might increase traditional agency costs. Third, and most importantly, we introduce a role for uncertainty. Under conditions of low(er) uncertainty, more accountability does not necessarily increase justification costs, which are apt to be low in any event, and does reduce traditional agency costs. But under conditions of uncertainty, accountability increases justification costs, potentially in an amount greater than any reduction in traditional agency costs; under some circumstances, reducing accountability, thereby granting managers more leeway, may be preferable. We propose a mechanism by which managers and stockholders can agree on granting managers some leeway for a specified period of time, in the form of "Control-Enhancing-Mechanisms" (CEMs). A CEM might, or might not, condition continuing leeway during the period on management's meeting certain agreed-upon conditions. We consider how our argument as to the existence of justification costs might apply in some private and public financial contexts, and suggest some solutions in those contexts as well.



Keywords: Accountability, Justification, Agency cost, Hostile takeover, Hedge fund activism, Dual-class shares, Tenure voting, Systemic risk, Corporate governance, Uncertainty, Entrepreneurship, Psychology

JEL Classifications: G23, G32, G34, G41, L26, K22



Claire A. Hill
James L. Krusemark Chair in Law
University of Minnesota, Law School
229 19th Avenue South
Minneapolis, MN 55455, United States
phone: +1 612 624 6521
e-mail: hillx445@umn.edu

Alessio M. Pacces*
Professor of Law and Finance
University of Amsterdam, Law School and Business School
Nieuwe Achtergracht 166
1001 NH Amsterdam, The Netherlands
phone: +31 104 081 613
e-mail: a.m.pacces@uva.nl

*Corresponding Author

# The Neglected Role of Justification under Uncertainty in Corporate Governance and Finance

*Claire A. Hill, University of Minnesota Law School*

*Alessio M. Pacces, Amsterdam Law School and Amsterdam Business School* *

## Abstract

The big corporate governance debates nowadays concern the corporation's time horizons, and the balance of power between shareholders and managers. In response to actual and anticipated pressure from shareholder activists – typically, activist hedge funds – companies are, some say, becoming too short-term. If this story is credited, shareholders, as well as the greater society are being harmed. We argue here that this story may reflect, at least in part, a heretofore neglected facet of decision-making: an actor's accountability, and consequently, her anticipated need to justify her decision in the case of a bad outcome.

Our account does three novel things. First, we demonstrate that the need to justify is pervasive. Our account identifies a type of agency cost, "justification costs," resulting from decisions motivated by justification. Under conditions of uncertainty, justification costs are higher. By contrast, in conditions of less uncertainty, the most justifiable decision is apt to be the decision made without regard to justification.

Second, to our knowledge, the relationship between these sorts of agency costs and more traditional agency costs, such as those involving self-dealing or empire building, has not been considered. Reducing traditional agency costs typically means increasing accountability and the consequent anticipated need for justification; by contrast, reducing costs of justification generally means increasing managerial leeway, which might increase traditional agency costs.

Third, and most importantly, we introduce a role for uncertainty. Under conditions of low(er) uncertainty, more accountability does not necessarily increase justification costs, which are apt to be low in any event, and does reduce traditional agency costs. But under conditions of uncertainty, accountability increases justification costs, potentially in an amount greater than any reduction in traditional agency costs; under some circumstances, reducing accountability, thereby granting managers more leeway, may be preferable.

We propose a mechanism by which managers and stockholders can agree on granting managers some leeway for a specified period of time, in the form of "Control-Enhancing-Mechanisms" (CEMs). A CEM might, or might not, condition continuing leeway during the period on management's meeting certain agreed-upon conditions. We consider how our argument as to the existence of justification costs might apply in some private and public financial contexts, and suggest some solutions in those contexts as well.

---

* Hill is Professor and James L. Krusemark Chair in Law. Pacces is Professor of Law and Finance and a research member of the European Corporate Governance Institute (ECGI). We wish to thank Margaret Blair, June Carbone, Douglas Cumming, Eric Hillemann, Jonathan Klick, Joe McCahery, Brett McDonnell, Georg Ringe, Andrew Winton and an anonymous referee for extremely helpful discussions and comments on drafts, and Jeffrey Siwik and particularly, Scott Dewey, for extremely helpful research assistance.

## 1. Introduction

The big corporate governance debates nowadays concern the corporation's time horizons, and the balance of power between shareholders and managers.[1] In response to actual and anticipated pressure from shareholder activists – typically, activist hedge funds – companies are, some say, becoming too short-term, shunning research and development expenditures, and hobbling their prospects (and perhaps their continued existence) by borrowing, paying out their available cash, raising cash via sales of their divisions, and otherwise excessively reducing expenditures, in order to distribute big sums quickly to shareholders.

We are now nearly recovered from a financial crisis in which housing prices increased precipitously and then collapsed, in part – perhaps in significant part – because many money managers made huge bets on housing as such bets became 'hot' and sought after, not doing enough of their own research but instead simply trying to make sure they could get as much as they could of the latest AAA rated issuance.

If these stories are credited, private actors – shareholders and clients of the money managers – as well as the greater society are being harmed. We argue here that these stories, with their short-termism and herding, may reflect, at least in part, a heretofore neglected facet of decision-making: an actor's accountability, and consequently, her anticipated need to justify her decision in the case of a bad outcome. Two examples quickly summon up the intuition, albeit in contexts far from the corporate and finance realm: "defensive medicine" and assessments of dangerousness of mental patients being considered for release. In the first case, the anticipated need for justification, especially in a case involving unusual symptoms, can yield excessive and costly testing.[2] In the second case, it can yield continuing confinement of a person who should not have been confined, since the decision-maker suffers far more releasing a dangerous person than continuing to confine a non-dangerous person. In both cases, the anticipated need for justification yields a decision that is based on something other than the best available assessment on the merits. We argue here that in the corporate and finance spheres as well, justification is a neglected factor in decision-making. Particularly under conditions of uncertainty,

---

[1] These questions have been at the core of the corporate governance debate for decades. See M. Becht, P. Bolton, and A. Röell, "Corporate Law and Governance", in A. M. Polinsky and S. Shavell, eds., *Handbook of Law and Economics*, Vol. 2 (North-Holland, 2007).

[2] M. Sanger-Katz, "A Fear of Lawsuits Really Does Seem to Result in Extra Medical Tests", *New York Times*, July 23, 2018, available at https://www.nytimes.com/2018/07/23/upshot/malpractice-lawsuits-medical-costs.html; A. Kachalia and M. M. Mello, "Defensive Medicine—Legally Necessary but Ethically Wrong? Inpatient Stress Testing for Chest Pain in Low-Risk Patients", 173 *JAMA Internal Medicine* 1056, 2013, doi:10.1001/jamainternmed.2013.7293.

justification-motivated decision-making can impose both agency costs and social costs. We focus mostly on the corporate realm, but also discuss some implications for finance.

What is new in our account is both less and more than initially appears to be the case. It is less insofar as management incentives in the general family of justification have been considered in the literature. Indeed, the tyranny of the markets, demanding results each quarter and smooth income trajectories, has long been bemoaned, and blamed for short-termist and other "safe" decisions such as minimizing research and development expenditures. In response to this rhetoric, the European Union has recently decided to abolish the obligation for listed companies to report financial results every quarter; the U.S. is considering following suit.[3] Consider the rationale often given when companies go private: that they need time that the market will not give them to make costly but ultimately value-enhancing changes. Michael Dell took Dell private a few years ago, giving precisely this rationale.[4] Indeed, corporate law has long been concerned with managers' ability and incentive to entrench themselves, and a body of Delaware corporate law, notably the *Unocal* doctrine, has arisen that nominally invokes judicial greater scrutiny when management entrenchment is a particular concern.[5] This concern is part of a broader story in the literature, including in our account, in which shortcomings in corporate performance are attributed to managerial agency costs.

---

[3] See the Directive EU 2013/50 of 23 October 2013. See also R. C. Pozen and M. Roe, "Keep Quarterly Reporting", *Brookings*, September 5, 2018, https://www.brookings.edu/opinions/keep-quarterly-reporting/. Interestingly, the implementation of the EU Directive in the UK does not seem to have produced the desired effects. Very few companies abandoned quarterly reporting and those that did it lost analyst coverage. Moreover, there seems to be no association between the frequency of reporting and investment in capital assets and R&D. See R. C. Pozen, S. Nallareddy, and S. Rajgopal, "Impact of Reporting Frequency on UK Public Companies", 3 *CFA Institute Research Foundation Briefs*, March 2017, available at https://www.cfainstitute.org/en/research/foundation/2017/impact-of-reporting-frequency-on-uk-public-companies.

[4] "The Rationale for a Private Dell", presentation to investors by Dell CEO Michael S. Dell, June 2013, available at https://epsnews.com/wp-content/uploads/2013/06/The-Rationale-for-a-Private-Dell.pdf. Interestingly, five years after going private, Dell has announced that it will be going public. A. Rosen, "Dell Is Going Public Again", *Boston Globe*, July 2, 2018, available at https://www.bostonglobe.com/business/2018/07/02/dell-going-public-again/ITzK26NxQeOR0VLUqhb9RP/story.html. An obvious cost at issue when companies go private is that public shareholders cannot share in the value creation. This is a common observation; a recent article in a business publication describes some recent examples. G. Colvin, "Take This Market and Shove It", *Fortune*, May 17, 2016, available at http://fortune.com/going-private/.

[5] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del., 1985); see also C. A. Hill, B. J. M. Quinn, and S. Davidoff Solomon, *Mergers and Acquisitions: Law, Theory, and Practice* (West Academic, 2016), 473-475, 478-479. Indeed, the reigning rationale for golden parachutes, provisions that pay management upon a change in control, is to counter the effects of their excess concern for their own jobs so as to make them be better agents, agreeing to a deal if it is in the best interests of their principal, the corporation (and its shareholders).

But our account does three novel things. First, we demonstrate that the anticipated need to justify is far more important than has previously been recognized. The need to justify is pervasive, and the people who may anticipate the need to justify their decisions include not just managers, but also their investors, who themselves may need to justify their results to their clients or beneficiaries. Moreover, what might count as a justification (beyond the obvious, immediate good results) has not been sufficiently well articulated.

Our account identifies a type of agency cost, "justification costs." Justification costs are costs resulting from decisions insofar as and to the extent that they are motivated by justification. The intuition is, again, captured by the examples above. But for the doctor's need to justify herself, she would not have ordered nearly as many expensive tests. Stated differently, under conditions of uncertainty, justification costs are higher. By contrast, in conditions of less uncertainty, the most justifiable decision is apt to be the decision made without regard to justification. Justification costs are agency costs because they are incurred to benefit the agent at the expense of the principal. They may also be social costs, harming the greater society.

Second, to our knowledge, the relationship between these sorts of agency costs and more traditional agency costs, such as those involving self-dealing or empire building, has not been considered. Reducing traditional agency costs typically means increasing accountability and the consequent anticipated need for justification; by contrast, reducing costs of justification generally means increasing managerial leeway, which might increase traditional agency costs.

Third, and most importantly, we introduce a role for uncertainty. Under conditions of low(er) uncertainty, more accountability does not necessarily increase justification costs, which are apt to be low in any event, and does reduce traditional agency costs. But under conditions of uncertainty, accountability increases justification costs, potentially in an amount greater than any reduction in traditional agency costs; under some circumstances, reducing accountability, thereby granting managers more leeway, may be preferable.

We propose a solution to the problem posed by justification costs in the corporate governance context – a mechanism by which managers and stockholders can agree on granting managers some leeway for a specified period of time, in the form of "Control-Enhancing Mechanisms" (CEMs). A CEM might, or might not, condition continuing leeway during the period on management's meeting certain agreed-upon conditions. We consider how our argument as to the existence of justification costs might apply in some private and public financial contexts, and suggest some solutions in those contexts as well.

*Overview of the Argument*

Our main focus is corporate governance. The paradigmatic reason, in theory, to constrain managers is that managers have the ability and incentive to benefit themselves at the expense of the firm and its shareholders. Unconstrained managers may seek to take advantage.

What sorts of managerial benefits are at issue? Traditional examples include a CEO and board who rebuff an acquirer so they can keep their jobs, or a CEO having his company make acquisitions as much or more so he can lead a larger company, with the associated compensation and prestige, as for the benefits to his company. We refer to the costs associated with managers' ability and incentive to pursue these benefits as "traditional" agency costs.

To constrain managers, why not just give the shareholders more power? As mentioned above, the power tends to be exercised by shareholder activists, a subset of shareholders whose interests, it is argued, may differ from those of all the shareholders, and of the corporation – and differ in a particular way: they may want the company to borrow an enormous amount or sell large portions of its business to pay out large dividends or make stock repurchases, without regard to whether doing so undermines the company's longer-term prospects. (Shareholder activists are arguably the successors to corporate raiders who, in attempting to acquire control of a company as cheaply as possible, may have been willing to threaten to freeze out the remaining shareholders at a low price, or who might talk shareholders into voting for something that would be less favorable to the corporation than what the managers were proposing.) Indeed, the specter of shareholder activist engagement may make company managers pre-emptively adopt short-termist or other strategies that are harmful to the company, the broader society, or both.

This is, of course, a highly contentious characterization. Managers might suffer from long-termism, postponing the realization of underperformance for want of better times that will never come.[6] And the shareholder activists, ostensibly as principals, acting for themselves, would (and do) say that they have a good idea as to how the company should be run, one that is superior to the incumbent management's idea.[7]

Of course, ex ante, it's not clear whether the management's idea, the activist's idea, or some other idea, is best. We would go even further, arguing that the characterization

[6] A. M. Pacces, "Exit, Voice and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance", 9 *Erasmus Law Review* 199, 2016, at 207.

[7] Indeed, the activist's idea may reflect an agency or agency-like cost: activists, too, need to justify their decisions and performance to their sources of funding.

of shareholder activists as being short-termist makes the concept seem far more determinate and intelligible than it is. First, there is no way to define short-termism objectively in a world in which the optimal allocation of capital to future projects is uncertain.[8] Second, the need for managers to justify under uncertainty creates a bias towards short-term performance. Third, this bias could be detrimental in contexts of high uncertainty, where it would be efficient for managers to be entrepreneurial, but the need to justify to shareholders prevent them from being such. While we take no position on whether short-termism is or not desirable, for we believe the answer depends on the particular company, we note that the claim that activist shareholders lead to short termism is both underspecified and unproven – as is the opposite claim that activist shareholders are not responsible for short-termism.

Managers and many shareholders (including activist investors as well as institutional investors generally) are and/or believe themselves to be accountable to others, who are themselves often accountable to others and/or believe themselves to be. They may be called to account if there is a bad outcome, even though the process they followed was thorough and otherwise appropriate, and untainted with self-interest. Or they may be called to account if there has not been a good outcome quickly enough. They therefore make their decisions with an eye towards future justification—of bad outcomes, or of outcomes that are not good quickly enough. Again, this holds true for the managers, the activists, and for institutional investors.

A manager making a decision for its justifiability may be imposing an agency cost to the extent that the outcome departs from what would be best for the principal, the corporation and its shareholders or, in the case of a money manager, the client.[9] Additionally, whether or not the decision-maker is an agent, a decision made for its justifiability may yield social costs. There is some, but not complete, overlap between the two types of costs. An obvious example is acceding to short-termist pressures and cutting back on a research and development project that might have led to significant monetary benefits to the company and significant health benefits to the broader society.[10] Institutional investors may be imposing an agency cost insofar as their

[8]For this reason, one of us has characterized shareholder activism as a "conflict of entrepreneurship". See Pacces, "Exit, Voice and Loyalty", supra note 6, at 207-211.

[9] M. C. Jensen and W. H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 3 *Journal of Financial Economics* 305, 308-310, 1976.

[10] Calling these "costs" is in a sense artificial – they suggest an implicit baseline relative to which the non-existence of a drug is worse, when there is no reason why the baseline 'should' include the existence of the drug. Wherever the baseline is, or even if no baseline can in principle be specified, the amounts at issue are appropriately considered costs. That is, the costs are either costs the society should not have to incur, such as the cost of pollution relative to pristine air, or foregone benefits, such as more money spent on drug development. For our purposes, we will simply call some set of consequences to the society from a move to short-term focused actions (research and development not pursued, radical reductions in immediate and short-

choices – with regard to investing and voting – generate lower returns than would be the case if they were not making decisions with justification in mind. And money manager herding in the years leading up to the financial crisis, motivated in significant part by concerns of justifiability, yielded an agency cost, as the managers' clients' returns suffered from the managers' purchase of overpriced low-quality securities, as well as an enormous social cost.

What sorts of strategies would be most readily justified? The obvious candidates are following a well-worn path, doing less,[11] and doing something with a quick payoff. These may be perfectly sensible strategies. But they are problematic when they don't represent the best assessment of how to proceed. When is that the case? This is where uncertainty comes in. By uncertainty, we mean Knightian uncertainty, a characterization of the future which does not yield a measurable prediction. Uncertainty is to be distinguished from risk, which is quantifiable and technically can be described by widely accepted probability distributions.[12] Uncertainty makes justification more difficult; accountability puts justification more in the forefront, as those who are accountable envision the greater difficulties of justifying their decisions made under uncertainty.[13] There are no established methods that can, ex ante, yield a sufficiently determinate prediction or sufficiently useful probability distribution; bad outcomes cannot be justified by reference to established methods. The problem of not being able to predict the future is of course pervasive. But with risk, there are conventional, and thus readily justifiable, ways to proceed—conventional strategies, in both the colloquial and technical uses of that term. A

term costs) or more "justifiable" actions "costs" even though we cannot specify a principled baseline. Hill discusses this point further in C. A. Hill, "The Rhetoric of Negative Externalities," 39 *Seattle University Law Review* 517, 2016.

[11] Consider in this regard the familiar finding that acts of omission are far less harshly judged than acts of commission. See, e.g., M. Spranca, E. Minsk, and J. Baron, "Omission and Commission in Judgment and Choice", 27 *Journal of Experimental Social Psychology* 76, 1991, available at https://www.sas.upenn.edu/~baron/papers.htm/oc.html.

[12] Frank Knight, *Risk, Uncertainty and Profit* (Houghton Mifflin, 1921), 19-20. "The practical difference is that in [risk] the distribution of the outcome in a group of instances is known (either through calculation a priori or from statistics of past experience), while in the case of uncertainty this is not true, the reason being in general that it is impossible to form a group of instances, because the situation dealt with is in a high degree unique." Ibid. at 233.

[13] The higher the uncertainty ex ante, the higher the hindsight bias ex post. See G. M. Gulati, J. J. Rachlinski, and D. C. Langevoort, "Fraud by Hindsight", 98 *Northwestern University Law Review* 773, 2004. In the absence of a conventional risk assessment justifying the decision at the outset, courts, peers, and investors may be more apt to infer misjudgment from a negative outcome. See also H. Spamann, "Monetary Liability for Breach of the Duty of Care?", 8 *Journal of Legal Analysis* 337, 2016.

conventional strategy largely assumes that the future will look like the past, and gives considerable credence to majority opinions.[14]

The more uncertainty there is, the more the most readily justifiable strategy may diverge from the decisions that the decision-maker thinks are best and would make but for the potential need for justification.[15] A company, and the society, might be better off if the company pursued its manager's best ideas, not her most-readily-justified ideas; both investors, and the society, might have been better off if money managers had not just followed the herd and had made their own assessments of investment quality.

That corporate actors are accountable and thus act with the need for justification in mind has some good effects. As we discuss, it helps address and minimize traditional agency costs. What a manager might do that would yield such a cost is familiar; the manager's knowledge that she will be asked to demonstrate that she is, for instance, not empire-building or hiring an unqualified relative, might serve as a constraint against her doing so. But the need for justification also has some potentially bad effects. For the most innovative businesses, the trajectory of how the business will proceed and evolve is notably unpredictable,[16] and the manager (and investor) will be particularly concerned with how to justify themselves should there be a bad outcome. Where the innovation is occurring at the outset of the enterprise, the

---

[14] According to Keynes, our judgments about the future, of which we know very little, are made conventionally. "In practice we have tacitly agreed, as a rule, to fall back on what is, in truth, a convention. The essence of this convention – though it does not, of course, work out quite so simply – lies in assuming that the existing state of affairs will continue indefinitely, except in so far as we have specific reasons to expect a change." J. M. Keynes, *General Theory of Employment, Interest and Money* (1936), 152 (Ch. 12, IV).

[15] Keynes later clarified that deciding conventionally includes, among other things, relying on the judgment of the majority of people:

> How do we manage in such circumstances to behave in a manner which saves our faces as rational, economic men? We have devised for the purpose a variety of techniques, of which much the most important are the three following:
>
> (1) We assume that the present is a much more serviceable guide to the future than a candid examination of past experience would show it to have been hitherto. In other words we largely ignore the prospect of future changes about the actual character of which we know nothing.
>
> (2) We assume that the *existing* state of opinion as expressed in prices and the character of existing output is based on a *correct* summing up of future prospects, so that we can accept it as such unless and until something new and relevant comes into the picture.
>
> (3) Knowing that our own individual judgment is worthless, we endeavor to fall back on the judgment of the rest of the world which is perhaps better informed. That is, we endeavor to conform with the behavior of the majority or the average. The psychology of a society of individuals each of whom is endeavoring to copy the others leads to what we may strictly term a *conventional* judgment.

J. M. Keynes, "The General Theory of Employment", 51 *Quarterly Journal of Economics* 212, 1937, at 214 (emphases in the original).

[16] C. M. Christensen, *The Innovator's Dilemma* (Harvard Business School Press, 1997).

managers and financiers can come together to decide on appropriate metrics for performance and the desired amount of oversight vs. leeway for the managers. But going forward, this becomes far more difficult, with perils present for excesses on both sides. In order to deal with an uncertain future, adaptation is crucial. However, the need for justification undermines adaptation of decision-making to new circumstances, encouraging as it does resort to known patterns, in effect, again, an assumption that the future will be like the past.

With this in mind, let us consider how the allocation of power between managers and those who would challenge them has been addressed in corporate law. The principal mechanisms that help management fend off activists and acquirers are early disclosure of shareholdings, staggered boards, poison pills, antitakeover laws, and, depending on how they are structured, dual class stock and tenure voting.[17] Managers with more ability to fend off activists and acquirers have more leeway, which includes leeway to take advantage—to impose traditional agency costs. But less leeway may yield more agency costs related to justification.

How do the two types of costs compare? And how should the fact that activists themselves face justification costs be taken into account? We argue that under conditions of uncertainty, the justification costs become a bigger factor, and may exceed the reduction in traditional agency costs that less leeway can yield.

We argue for a new mechanism: through agreement with shareholders, managers of existing public companies should be able to be insulated from removal for a specified period of time, using a CEM. Our mechanism would be contractual. It would be chosen by companies, agreed to by shareholders, and tailored for companies' particular circumstances. In particular, the company's management – or the controlling shareholder, if there is one – would need to persuade outside (institutional) investors that their 'big idea' warrants a period of leeway, during which they would not have to fend off shareholder activists. The leeway could be for a specified period of time; it might, too, be subject to being shortened if specified thresholds or conditions were not met. Proceeding in this way should have significant benefits over alternatives such as taking the company private, while yielding other efficiencies, such as making the prospective returns on innovation available to the investing public. We expect that this mechanism would principally be used under conditions of greater uncertainty.

[17] Neither antitakeover laws nor pills without staggered boards are effective against activists; indeed, pills without staggered boards aren't particularly effective at all. See our discussion of this point in Section 3, infra.

We briefly discuss the role of justification in other contexts as well, including as to both private and public actors in the financial realm.[18] As to the former, we suggest a change to law that could discourage justification-motivated decision-making by money managers. As to the latter, we suggest ways to make financial policymakers more entrepreneurial in various contexts, and in particular, more responsive to changed circumstances.[19]

Our account is largely, although not exclusively, within the rational paradigm. It is within the rational paradigm insofar as it concerns self-interest that, in the case of agents, has costs to their principals, and in the case of agents and principals, has costs to the broader society, or at least, deprives the society of what would have been beneficial expenditures. It differs insofar as the rational paradigm and indeed, even behavioral work, treats 'reality' as ultimately discernible – a person is 'overconfident,' for instance, where the 'correct' level of confidence is known or somehow knowable.[20] Again, a critical feature of uncertainty is that the possible outcomes and associated probabilities the future presents are not necessarily knowable even within a broad range. Ex ante and even ex post, we may not know, for instance, whether a manager's idea was 'wrong.'[21] Circumstances may yield a bad ex post result; the result may reflect some defect in the idea, or it may not.

---

[18] One intriguing article, by Professors McDonnell and Schwarcz, suggests a role for "Regulatory Contrarians" in helping regulators consider other perspectives, including perspectives uninfluenced by justification concerns. B. McDonnell and D. Schwarcz, "Regulatory Contrarians", 89 *North Carolina Law Review* 1629, 2011. We discuss this article and this suggestion further in the text accompanying notes 317-321.

[19] For the theoretical framing of this problem in financial regulation, see H. Nabilou and A. M. Pacces, "The Law and Economics of Shadow Banking", in I. H.-Y. Chiu and I. G. MacNeil, eds., *Research Handbook on Shadow Banking: Legal and Regulatory Aspects* (Edward Elgar Publishing, 2018), https://www.elgaronline.com/view/edcoll/9781785362620/9781785362620.00008.xml.

[20] One of us has written extensively on this issue. See, C. A. Hill, "Beyond Mistakes: The Next Wave of Behavioural Law and Economics", 29 *Queen's Law Journal* 563, 2004; C. A. Hill, "A Positive Agenda for Behavioral Law and Economics", 3 *Cognitive Critique* 85, 2011.

[21] Behavioral law and economics, in our view, has come to have two different and, to some extent conflicting, meanings. The original meaning, and one that still has considerable viability, is that behavioral law and economics concerns mistakes and altruism, thus contrasting (and disagreeing) with law and economics, which hypothesizes lack of systematic mistake-making and self-interest. This is not the sense in which we are using the term "behavioral law and economics." Rather, we use the term as it is meant when applied to George Akerlof and some other scholars, to explore dimensions of rational behavior not typically explored in the standard economic models. Consider in this regard not only Akerlof's recent work on identity, but even his famous lemons paper (G. A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism", 84 *Quarterly Journal of Economics* 488, 1970). Going further than Professor Akerlof and his co-authors, we question the dichotomy between good and bad decisions implicit in the labels rational and irrational. Uncertainty may make it impossible to know even in theory whether a decision is rational or irrational, or correct or incorrect, when it is made or for some time afterwards. Because all decisions about the future are

In sum, uncertainty in dealing with the future is pervasive, and so is the need for agents and others to justify their decisions. Our contribution in this article is to bring a consideration of justification costs and notably, justification costs under uncertainty, into the realm of corporate governance analysis, focusing on when uncertainty might warrant more leeway for managers. When uncertainty is low, accountability should be higher, which would naturally lead to decision-making made more with justification in mind—that is, more conventional decision-making. But this should not yield an increase in justification costs insofar as the most justifiable decision is also the decision that would have been made had justification not been at issue. By contrast, when uncertainty is higher, decision-making leeway, or discretion, should be higher, so as to encourage non-conventional decision-making. The new mechanisms and rules we propose allow the quantum of accountability to change over the lifecycle of publicly held enterprises, as well as during market cycles to which policymakers may be pressured to react.

Our article proceeds as follows.

Section 2 argues that the traditional framing of corporate governance debates neglects the role of justification and in particular, justification under uncertainty, instead being undergirded by incomplete accounts of parties' interests and aptitudes and parties' views of each other's interests and aptitudes. In the canonical paradigms, managers might take advantage or have bad ideas, something that can and should be limited by appropriate incentive alignment, constraints and market discipline. Or, shareholders activists are out for themselves, not shareholders generally, and hence, their ability to force managers to listen to them should be limited. The lens of insufficiently constrained traditional self-interest on the part of managers obscures the role of justification under uncertainty—of managers as well as investors. No distinction is made between managers who would use leeway to benefit themselves and those who would use leeway to follow their best judgment. The need to justify acts as an efficient constraint on the first situation, but is inefficient in the second. Likewise, institutional investors who need to justify to the individuals or entities whose money they are ultimately investing insist that managers are accountable in

made under uncertainty, they cannot be rational or irrational in the traditional sense. They are as rational as they can be (H. A. Simon, "A Behavioral Model of Rational Choice", 69 *Quarterly Journal of Economics* 99, 1955) or, to put it as Keynes (*General Theory of Employment,* supra note 14, Ch. 12, IV, pp. 152-153) did, they are rational inasmuch as they rely on a convention. In the law and economics literature, Richard Posner ("Shorting Reason", *The New Republic*, April 15, 2009) criticized Akerlof and Shiller's behavioral account of Keynes' notion of animal spirits. Compare Keynes, *General Theory of Employment,* supra note 14, Ch. 12, VII, pp. 161-163, with G. A. Akerlof and R. J. Shiller, *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism* (Princeton University Press, 2009).

their turn. But when uncertainty is high, there is more call for entrepreneurial judgment, and thus less benefit from the constraints the need for justification imposes.

In some respects, this is not so different from the standard story – managers who claim to want time to let their ideas pay off, vs. investors who are guarding against manager advantage-taking and incompetence and can't tell if the managers are telling the truth or not. And it's not as though there is a 'fact of the matter' as to advantage-taking vs. incompetence. A manager might genuinely think the comfortable way he has done things and wants to continue doing things (or, for that matter, the risky way he wants to try) is the right way. It may not be known until later, if ever, if the manager was right. What our account does is to stress the extent to which conventional reactions to uncertainty can harm firms and harm society, and suggest ways to give managers constrained leeway that could yield a better result for shareholders as well as society.[22]

In Section 3, we briefly explore the history and some present-day contexts in which the principal corporate governance debates as to corporate time horizons and the allocation of power between managers and shareholders, are played out in the U.S. and in Europe.

Our summary of the history and context includes discussions of the background legal regime (as to the U.S., notably the Section 13(d) regime and antitakeover laws), but we focus mainly on mechanisms such as staggered boards, poison pills, dual class shares, and tenure voting/loyalty shares. Most of the discussion concerns the U.S., where some of the mechanisms are more widely employed and ruled on by courts, but European practices and legislation are discussed as well, particularly with regard to dual class and loyalty shares. Our main point is that these mechanisms all assume that the corporate governance problem to be addressed is how to balance the need for managerial leeway (what one might call a "less accountability" regime) with the need for more accountability to guard against managers' incentive and ability to take advantage in traditional ways, without taking into account the role justification costs should play.

Section 4 sets forth and defends our proposal for giving managers leeway for a limited period of time under certain circumstances, contrasting it with other mechanisms

[22] Indeed, even readers not persuaded that justification is an important motivation might favor our solution so long as they are persuaded that short-termism is a problem that markets are not on track to correct. See C. A. Hill and B. McDonnell, "Short and Long Term Investors (and Other Stakeholders Too): Must (and Do) Their Interests Conflict?", in C. A. Hill and S. Davidoff Solomon, eds., *Research Handbook on Mergers and Acquisitions* (Edward Elgar Publishing, 2016), 396-415.

discussed in Section 3. We argue that managers should be able to negotiate with the corporation's shareholders (or minority shareholders, if the managers are the corporation's controlling shareholders) for the issuance of dual class shares which would give managers (and controlling shareholders owning less than a majority of the shares) control of the corporation for a specified period of time under certain circumstances.

Section 5 discusses additional applications of our framework in other spheres in private and public finance.

Section 6 concludes.

## Section 2: A Role for Justification in Corporate Governance

***The Classic Articulation of the Manager vs. Activist Debate***

The debate over the allocation of power between shareholders and managers typically gives traditional agency costs an important role. Perhaps overstating, but only slightly, traditional agency costs are the problem that corporate governance needs to solve. Shareholders want to invest, and want the corporation to be managed on their behalf. But managers have the ability and incentive to benefit themselves at the expense of their principals (the corporation and its shareholders).[23]

Common sense, and considerable evidence, supports the proposition that managers can and do take advantage in some at least weak sense of the term—that is, they behave in a manner that they might not behave in but for the benefits to themselves and their belief that they can, without much harm to themselves, take those benefits. But how strong a factor are traditional agency costs relative to other forces affecting corporate governance? We argue here that there are other forces and costs that have not been sufficiently acknowledged.

In the past few years, the debate has pitted managers against activist shareholders, typically hedge funds, whose business model is to choose a few companies they think ought to be behaving very differently, and to pressure the companies accordingly. The

[23] For ease of exposition, we largely cast the debate as pitching pro-management forces against pro-activist shareholder forces. We know, of course, that this is a simplification on many fronts, and in particular, in recent times, the roles of long-term institutional investors have become far more important, something we discuss later in this article, in the text accompanying notes 77-89.

opposing positions, pro-management vs. pro-activist, are strongly held, and strongly defended.[24]

The debate embeds two competing paradigms or prototypes. One gives prominence to managers taking advantage in canonical ways. Here is Dan Loeb of Third Point, in a public letter to Sotheby's management:

> A review of the Company's proxy statement reveals a perquisite package that invokes the long-gone era of imperial CEOs: a car allowance, coverage of tax planning costs, and reimbursement for membership fees and dues to elite country clubs. . . . Typical of the egregious examples was a story we heard of a recent offsite meeting consisting of an extravagant lunch and dinner at a famous "farm-to-table" New York area restaurant where Sotheby's senior management feasted on organic delicacies and imbibed vintage wines at a cost to shareholders of multiple hundreds of thousands of dollars. We acknowledge that Sotheby's is a luxury brand, but there appears to be some confusion—this does not entitle senior management to live a life of luxury at the expense of shareholders.[25]

Relatedly, there are criticisms that "performance-based" compensation is paid for bad performance. From Trian's letter to shareholders about the Dupont Corporation:

- The Board's compensation practices have actually rewarded management for failing to meet its targets. In 2013, management's long-term incentive plan had

[24] We note here, though, that the help empirical work can offer to settle the debate is limited. Opponents of hedge fund activism argue that the activists inject short-termism into corporate governance and that as is the case with hostile takeovers, short-termism is conducive to poorer long-term performance and lowers social welfare. Supporters of hedge fund activism contend that it is a welcome market response to managerial shirking and incompetence, more effective than hostile takeovers because of its lower cost. As we have argued independently in previous work, this debate cannot be resolved by empirical analysis. First, companies that are engaged by activists differ from those that are not engaged—hedge fund activists do not select companies at random. Second, a large part of activism takes place behind closed doors, or is simply anticipated by the potential targets. These circumstances are not reflected by the data; the data can only include what is observable. Both issues fatally undermine the counterfactual of any statement to causality, be that in favor or against the role of hedge fund activism in corporate governance. A. M. Pacces, "Shareholder Activism in the CMU", in D. Busch, G. Ferrarini, and E. Avgouleas, eds., *Capital Markets Union in Europe* (Oxford University Press, 2018), 511-512. See also C. A. Hill, "An Identity Theory of the Short- and Long-Term Investor Debate", 41 *Seattle University Law Review* 475, 2018; Hill and McDonnell, "Short and Long Term Investors", supra note 22.

[25] Email from Daniel S. Loeb, CEO of Third Point, to William F. Ruprecht, CEO Sotheby's (Oct. 2, 2013), http://www.sec.gov/Archives/edgar/data/823094/000119312513388165/d605390dex993.htm [https://perma.cc/427M-SQDB].

a payout of 113% of target despite a total shareholder return (a key metric of determining the payout) in the 25th percentile of DuPont's peers.

- That same year, short-term compensation payout was almost 90% despite adjusted EPS growth of 3%, significantly below the Company's long-term target of 12% EPS growth.
- In 2014, the Board's Human Resources and Compensation Committee acknowledged poor operating performance as it exercised "negative discretion" and gave management a 0% payout factor for "corporate performance" under DuPont's short-term incentive program. However, the Human Resources and Compensation Committee (chaired by Lois Juliber and including Mr. Cutler and Lee Thomas as members) still found a way to pay management by giving an 80-100% payout factor for "individual performance."[26]

Besides taking what (from the critic's perspective) are unwarranted benefits, there are also critiques of managerial performance, such as continuing in the same path when new thinking (and new personnel) might be needed. Returning to Loeb's letter to Sotheby's:

> We acknowledge that you, [then-CEO] Ruprecht, were an able steward for the Company following both the price fixing scandal in 2000 and the financial crisis in 2008. Unfortunately, you have not led the business forward in today's art market…. Our research suggests Sotheby's crisis of leadership has created dysfunctional divisions and a fractured culture. There is a demoralizing recognition among employees that Sotheby's is not at the cutting edge – demonstrated by the Company's inability to even *develop* a coherent plan for an internet sales strategy, much less *implement* one.
>
> …
>
> As with any important restoration, Sotheby's must first bring in the right technicians….
>
> It is also time, Mr. Ruprecht, for you to step down from your positions as Chairman, President and Chief Executive Officer and for the role of Chairman to be separated for your successor….Sotheby's requires a CEO with sufficient knowledge of the global art markets to make critical decisions, who can move

[26] "Trian Sends Letter to DuPont Stockholders", *Business Wire*, April 9, 2015, available at https://www.businesswire.com/news/home/20150409005459/en/Trian-Sends-Letter-DuPont-Stockholders.

> seamlessly around the globe building the business and strengthening client relationships. Respectfully, we do not see evidence that you are the right person to repair the Company and drive its growth in today's dynamic global art market. [27]

The competing paradigm, that shareholder activists are out to 'take the money and run,' is described in this American Lawyer article:

> [A]ctivists are billionaire hedgies who are out to make a quick buck, while driving great companies and the economy into a ditch. Studies find that activists typically hold a stock for only nine months before bailing out. In that short time, they will aim at all costs to hack employment, R&D and capital expenditures; overload the company with debt; return money to shareholders through dividends and buybacks; and, as the ultimate goal, goose the stock through M&A activity. "At bottom, every activist campaign is one or two steps to sell the company," says [a partner at Wachtell, Lipton, Rosen & Katz, Neff. The Wachtell firm, and in particular, partner Marty Lipton, invented the poison pill, which helps management keep unwanted (to them) acquirers at bay.][28]

Consider the concerns about these actors as embedded in these accounts. The pro-activist/anti-management accounts describe managers who are out for more money for themselves, and are rather less concerned about earning it for the company. Or maybe the managers think old or mistaken ways of managing the company are good ones, but, the intimation is, they haven't thought hard enough about what would be good, which might include them not leading the company. The anti-activist account describes people who seek short-term positive effects without regard to damage in the longer term: the company is "overloaded" with debt, and the stock is "goosed."[29] Traditional self-interest is being pursued in all of these stories – more money (or a continuing entitlement to the same money), whether or not the pursuer deserves it. Exacerbating the problem, the specter of activists can cause even companies that have not (yet?) attracted activist engagement to pre-emptively do what activists would

---

[27] Loeb email, supra note 25.

[28] M. D. Goldhaber, "Marty Lipton's War on Hedge Fund Activists," *The American Lawyer* (Online), March 30, 2015, available at https://www.law.com/americanlawyer/almID/1202721058301/?slreturn=20180206125103.

[29] Perhaps only for a short while, as is the case with goosing (pinching) people? Goosing also means pushing or encouraging, so perhaps the price rise would be permanent, although those objecting to activists tend to argue that the stock price rises are only in the short term. "Goose", *Oxford Learner's Dictionary Online*, https://www.oxfordlearnersdictionaries.com/us/definition/english/goose_2. See also "Goose", *Cambridge Dictionary Online*, https://dictionary.cambridge.org/dictionary/english/goose.

want them to do, which is by hypothesis problematically short-termist, as the managers seek to hold onto their jobs.[30]

There are some middle ground positions on the management vs. activist debate, tempering praise or criticism of one side or the other, or suggesting that good accommodations could be or are made, including that companies can, should, and/or do get the benefit of activist insights while avoiding a more formal and adversarial activist 'engagement' or battle. One middle ground position is the activist-as-one-(sometimes good) trick-pony position, as described in an article from January of 2015:

> Activist investors are like UPS drivers. They turn in only one direction.
>
> By now, the activists' rise is remarkable for its sheer scale and ferocity…Their rise is also remarkable for another thing: their intellectual sameness. Plot a map of the 10 largest activist firms and you will find that seven of them are based within 17 blocks of each other in midtown Manhattan. The vast majority are making similar demands of their targets, delivered with what now feels like a dull percussion: Raise the dividend, buy back shares, cut these costs, spin off that division, sell the company. What's the average length of an activist shareholding? Some 84% don't last more than two years, according to FactSet. Many of their grievances are built around the idea that companies are misallocating their capital. In this worldview, that capital is typically going toward bad long-term projects, such as AOL Inc.'s ill-fated local news service Patch or the research budget at Allergan Inc. *Many times they are right*… [But why] can't activists find targets where the misallocation is going the other way? In other words, identify companies that are playing it too safe, perhaps pushing too much into dividends or buybacks. Or missing a great opportunity in a new market.[31]

What keeps corporate governance from working better is, according to the pro-activist camp, largely, agents' self-interested behavior that harms, or at least does not help, their principal by insulating the agent from threats to her job and allowing her to retain private benefits of control. (Assumed, probably correctly, in this account is that traditional legal mechanisms of accountability such as lawsuits by shareholders arguing that directors have breached their fiduciary duties will not succeed, and may

[30] J. C. Coffee, Jr. & D. Palia, "The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance", 41 *Journal of Corporation Law* 545, 2016.

[31] D. K. Berman, "A Radical Idea for Activist Investors: What If the Goal Were More Investment With an Eye on the Long Term?", *Wall Street Journal Online*, January 27, 2015, available at https://www.wsj.com/articles/a-radical-idea-for-activist-investors-1422370260 (emphasis added).

not have that much force in restraining the behavior at issue.) The primary challenge for corporate governance is therefore to reduce agency costs by aligning agents' incentives or by doing a better job monitoring (or otherwise constraining) them. The opposing camp thinks that these agency costs pale next to those arising from hostile acquirers and shareholder activists, who have found ways to benefit themselves while not benefitting the corporation or its (other) shareholders. Both camps, as well as the middle ground position discussed above, frame the issues around the negative effects of someone's self-interest in getting more money. The corporate managers' or the activists' pursuit of money is shafting the corporation and its shareholders (or in the case of the activist, the corporation's other shareholders). A person's view as to what law should and should not allow, and what techniques used by managers and shareholders are good, turns importantly on her view of and appraisal of what managers and shareholders are apt to do. Courts' deference to directors' business judgment has not really been questioned, but those taking more seriously the perils of traditional agency costs of the sort described above favor more power for shareholders, while those for whom shareholder advantage-taking is the more serious threat favor more power for managers.

***A Role for Uncertainty***

We think this depiction of managers and shareholders, in which much is determinate, neglects a very important motivator of conduct, arising because of how much is actually indeterminate. Agents are accountable to their principals (and, potentially, others as well, notably their peers as well as, potentially, regulators), and anticipate needing to justify their decisions and the results thereof. This anticipation affects their decision-making. The effect can be especially pernicious when uncertainty is higher. In such contexts, decisions motivated by justification are particularly likely to depart from what is in the principal's best interests, for reasons we explain below. Such departures constitute an agency cost, one that has, to our knowledge, not previously been sufficiently recognized.[32] Briefly summarizing our argument, the anticipated need to justify may lead decision-makers to emulate others (herding) or otherwise use more recognized and formulaic (conventional) approaches, or seek demonstrable results quickly (short-termism). Insofar as we are in a realm of uncertainty, where the future is particularly indeterminate, the herd doesn't necessarily know best, and there is no particularly good reason to suppose recognized and formulaic approaches are best. Seeking demonstrable results short-term unduly limits consideration of projects with longer time horizons. With prediction of the

[32] We discuss how our account of agency costs compares with the existing corporate governance literature infra, note 52.

outcome more difficult, the anticipated need to justify assumes more importance in the decision-making process. Agency costs associated with justification might seem to counsel less accountability and thus less need for justification. But accountability is helpful in reducing traditional agency costs. Our account explains how to strike the appropriate balance.

Costs associated with justification are not just to the agents' direct principals; they are societal as well. Again, consider in this regard the extent to which retrenchments in research and development spending for projects with long-term time horizons might yield fewer medical and other advances; consider as well the extent to which investor herding into subprime securities contributed to the 2008 financial crisis.

In sum, dealing with uncertainty with a view towards justification can deprive both companies and the broader society of the benefits of entrepreneurship.

## ***<u>What is Uncertainty?</u>***

In Frank Knight's seminal 1921 book *Risk, Uncertainty and Profit*, Knight defined uncertainty, distinguishing it from risk:

> Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated. The term "risk," as loosely used in everyday speech and in economic discussion, really covers two things which, functionally at least, in their causal relations to the phenomena of economic organization, are categorically different. . . . The essential fact is that "risk" means in some cases a quantity susceptible of measurement, while at other times it is something distinctly not of this character; and there are far reaching and crucial differences in the bearings of the phenomenon depending on which of the two is really present and operating. . . . It will appear that a measurable uncertainty, or "risk" proper, as we shall use the term, is so far different from an unmeasurable one that it is not in effect an uncertainty at all.[33]

As Knight importantly recognized, the future is in many significant respects uncertain. Not only can the future not be known, but also, our tools for predicting it, using a set of events with associated probabilities, are imperfect, suggesting that far more is known than is actually the case. It is trivially true that everything is uncertain.

[33] Knight, supra note 12, at 19-20.

But some things are more uncertain than others. As we discuss at greater length below, mature businesses with established cycles seem less uncertain than a new technology start-up. The former can plausibly be treated as mostly involving risk; this is far less true of the latter. That being said, over time, established firms may face more uncertainty, and start-ups may face less. A mature business may be doomed to fail in the absence of long-term investments in innovation. Likewise, companies old and new may go bankrupt if they do not react on a timely basis to short-term challenges such as macroeconomic shocks.[34] For all companies, new circumstances – a new market, a new product, a new business model – may arise. Making adaptation to change difficult, Knight explains, is that "the existence of a problem of knowledge depends on the future being different from the past while the possibility of the solution of the problem depends on the future being like the past."[35]

If the future is sufficiently like the past, methods to deal with risk can be successfully used. Risk is tractable because, in principle it can be described as a finite (known) set of events with associated (known) probabilities. Statistical models of risk assessment rely on observational data about past events of the same sort (that is, classified as being of the same sort) as the subsequent event the risk of which is sought to be assessed, the events' frequency, and the shape of their distribution. Again, the conventional assumption underlying these models is that the future can be extrapolated from the past.[36] Use of a conventional risk assessment suggests that the

---

[34] See, e.g., M. Giannetti and X. Yu, "Adapting to Radical Change: The Benefits of Short-Horizon Investors", ECGI (European Corporate Governance Institute) Finance Working Paper No. 467/2017, 2017, available at http://www.ecgi.global/sites/default/files/working_papers/documents/4672017.pdf (finding that companies with more short-term investors react more quickly to permanent negative shocks). See also D. Hackbarth, A. Rivera, and T.-Y. Wong, "Optimal Short Termism", ECGI Finance Working Paper No. 546/2018, 2018, available at http://people.bu.edu/dhackbar/HRW-2018.pdf (finding that short-termism is optimal for certain companies, particularly those with low growth prospects and comparatively higher debts).

[35] Knight, supra note 12, at 313.

[36] As Keynes observed:

> In practice we have tacitly agreed, as a rule, to fall back on what is, in truth, a *convention*. The essence of this convention — though it does not, of course, work out quite so simply — lies in assuming that the existing state of affairs will continue indefinitely, except in so far as we have specific reasons to expect a change. This does not mean that we really believe that the existing state of affairs will continue indefinitely. […] Nevertheless the above conventional method of calculation will be compatible with a considerable measure of continuity and stability in our affairs, *so long as we can rely on the maintenance of the convention.*

Keynes, *General Theory of Employment,* supra note 14, at 152 (emphasis in original).

As an illustration of this, consider the hypothesis testing in much of the empirical analysis that is carried out today. To determine whether a result in a sample of observations – for instance, a correlation between takeover defenses and firm value – is statistically significant, researchers perform a test providing information about the probability to observe the same result when there is actually no correlation in the real world. In statistics, this situation is called the null hypothesis. Results are significant when the null hypothesis can be rejected future is more predictable, and hence can be dealt with more effectively, than our knowledge allows us to say.[37]

Because dealing with uncertainty is difficult, one common strategy used is to treat it as risk.[38] Certainly, the vocabulary and structure of risk are commonly used. One scholar notes that "work in organizational theory suggests that most decisions are actually made in absence of calculable probabilities and under conditions of enormous contingent complexity, although they may be presented as if they were mechanical."[39] Knight distinguishes between those who treat uncertainty as risk – who proceed as though the future will be like the past[40] – and those who do not, instead using their intuition, calling the latter "entrepreneurs."

## ***Justification under Uncertainty***

The preceding discussed decision-making and in particular, decision-making under uncertainty. Let us now return to the role of justification. Market actors often have to explain and justify their decisions. This is particularly true after a bad outcome, but it can also be true at any time before 'nature' acts – that is, before there is an outcome that can be assessed. The justifications have to pass muster with the relevant community: shareholders and other financiers, peers, and perhaps, courts and

---

persuasively. Who defines what counts as persuasively? It is, again, a convention. In particular, results are considered statistically significant when the probability that the hypothesis is being rejected when it is actually true (a type I error, or a false positive) is equal or lower than 5%. The probability could be a different percentage, but 5% is the one conventionally accepted.

[37] See Keynes, "The General Theory of Employment", supra note 15, at 213-214:

> By "uncertain" knowledge, let me explain, I do not mean merely to distinguish what is known for certain from what is only probable. The game of roulette is not subject, in this sense, to uncertainty; nor is the prospect of a Victory bond being drawn. Or, again, the expectation of life is only slightly uncertain. Even the weather is only moderately uncertain. The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence, or the obsolescence of a new invention, or the position of private wealth-owners in the social system in 1970. About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know. Nevertheless, the necessity for action and for decision compels us as practical men to do our best to overlook this awkward fact and to behave exactly as we should if we had behind us a good Benthamite calculation of a series of prospective advantages and disadvantages, each multiplied by its appropriate probability, waiting to be summed.

[38] A. M. Pacces, "Illiquidity and Financial Crisis", 74 *University of Pittsburgh Law Review* 383, 2013. Uncertainty aversion (also known as ambiguity aversion) is a well-documented phenomenon in the literature. See, e.g., M. J. Machina and M. Siniscalchi, "Ambiguity and Ambiguity Aversion", in M. J. Machina and V. K. Viscusi, eds., *Handbook of the Economics of Risk and Uncertainty* (Elsevier, 2014), 729-807.

[39] Michael Power, *Organized Uncertainty: Designing a World of Risk Management* (Oxford University Press, 2007), 13-14.

[40] According to Knight, "[C]hange according to known law […] does not give rise to uncertainty." Knight, supra note 12, at 313.

regulators. When making any not-completely-inconsequential or routine decision, market actors will typically consider how they would justify themselves should they be called upon to do so. But the more consequential decisions and the less routine ones may entail a considerable degree of uncertainty and are hence potentially more difficult to justify. Actors who anticipate needing to justify their decisions will therefore tend to choose the more conservative or conventional course of action, in which the impact of uncertainty is minimized, so that they can justify a bad outcome based on some existing accepted methodology such as a probability distribution.

Justification is ultimately about accountability – the need to justify is a recognition that one is accountable. Accountability is "a fundamental feature of organizational life."[41] Accountability has a significant effect on decision-making.[42] Whether accountability generally yields better decisions is debated, as is, if it does yield better decisions, what form accountability should take to elicit the best decision-making. There is extensive literature, for instance, on whether accountability for process or accountability for outcomes produces better decisions. There is, not surprisingly, no definitive answer, especially given the vast variety of possible contexts.[43] Some work

---

[41] S. V. Patil, P. E. Tetlock, and B. A. Mellers, "Accountability Systems and Group Norms: Balancing the Risks of Mindless Conformity and Reckless Deviation", 30 *Journal of Behavioral Decision Making* 282, 2017, DOI: 10.1002/bdm.1933.

[42] The literature on accountability is voluminous. See, e.g., ibid.; P. E. Tetlock and B. A. Mellers, "Structuring Accountability Systems in Organizations: Key Trade-Offs and Critical Unknowns", in B. Fischhoff and C. Chauvin, eds., *Intelligence Analysis: Behavioral and Social Scientific Foundations* (National Academies Press 2011), 249-270, available at https://www.nap.edu/read/13062/chapter/16; P. E. Tetlock, "Accountability and Complexity of Thought", 45 *Journal of Personality and Social Psychology* 74, 1983; P. E. Tetlock, "Accountability—A Social Check on the Fundamental Attribution Error", 48 *Social Psychology Quarterly* 227, 1985; P. E. Tetlock and J. I. Kim, "Accountability and Judgment Processes in a Personality Prediction Task", 52 *Journal of Personality and Social Psychology* 700, 1987; P. E. Tetlock and R. Boettger, "Accountability—A Social Manager of the Dilution Effect", 57 *Journal of Personality and Social Psychology* 388, 1989; P. E. Tetlock, "Social and Cognitive Strategies for Coping with Accountability—Conformity, Complexity, and Bolstering", 57 *Journal of Personality and Social Psychology* 632, 1989; P. E. Tetlock, "The Impact of Accountability on Judgment and Choice—Toward a Contingency Model", 25 *Advances in Experimental Social Psychology* 331, 1992; P. E. Tetlock and R. Boettger, "Accountability Amplifies the Status-Quo Effect When Change Creates Victims", 7 *Journal of Behavioral Decision Making* 1, 1994; J. S. Lerner, J. H. Goldberg, and P. E. Tetlock, "Sober Second Thought: The Effects of Accountability, Anger, and Authoritarianism on Attributions of Responsibility", 24 *Personality and Social Psychology Bulletin* 563, 1998; J. S. Lerner and P. E. Tetlock, "Accounting for the Effects of Accountability", 125 *Psychological Bulletin* 255, 1999; P. E. Tetlock and B. A. Mellers, "Intelligent Management of Intelligence Agencies Beyond Accountability Ping-Pong", 66 *American Psychologist* 542, 2011; P. E. Tetlock et al., "Accountability and Ideology: When Left Looks Right and Right Looks Left", 122 *Organizational Behavior and Human Decision Processes* 22, 2013; W. Chang et al., "Accountability and Adaptive Performance under Uncertainty: A Long-Term View", 12 *Journal of Behavioral Decision Making* 610, 2017.

[43] Among the scenarios as to which there have been tests are—those in which what constitutes good process is agreed upon, those in which the result of the decision can or cannot be reversed, how consequential the decision is, and to what extent 'doing the same thing' as one previously did is possible. See Chang et al., supra note 42; W. F. Messier, L. A. Quick, and S. D. Vandervelde, "The Influence Of Process Accountability And

has considered accountability under uncertainty, where the right answer is not known by anyone, or where there is no consensus best practice that "leads to desired outcomes."[44] But studying decisions analogous to the types of decisions we are concerned with is difficult. The decisions to be made in the corporate context are highly consequential and often, they are highly uncertain too. In the real world, there are too many confounding factors; in an experimental setting, where the confounding factors can be controlled, there is a significant limit on how consequential the effects of the decision, including on the decision maker, can be. After all, conducting an experiment where the result of doing badly is the loss of a job is not possible, nor are natural experiments or existing data always amenable to making plausible extrapolations.[45] The closest analogue that can be studied in the real world is probably medical decision-making, which we discuss below. Notably, medical decision-making is notorious for sometimes inspiring justification-motivated decisions that are not optimal.

What is considered a satisfactory justification? There are two obvious alternatives. One is to proceed using conventional criteria and metrics that are recognized as acceptable in the relevant community. [46] ('This is what is generally done.' 'This is what others are doing.') An alternative is to seek to produce (good) results so quickly that the results themselves serve as the justification – so that, it is hoped, no further justification is needed. Stated differently, conventional justificatory strategies can be either process-based or outcome-based.[47]

---

Accounting Standard Type On Auditor Usage Of A Status Quo Heuristic", 39 *Accounting, Organizations and Society* 59, 2014; Patil, Tetlock, and Mellers, supra note 41.

[44] Chang et al., supra note 42.

[45] But, again, we know that accountability affects decision-making, and that in particular contexts, certain types of process or outcome accountability were better or worse; there is no general finding, even that accountability makes for better or worse decisions than no accountability. A recent article co-authored by leading researchers in the field "[cautioned] against a black-and-white perspective on the pros and cons of process and outcome accountability," noting that "Each system has its advantages and disadvantages." Patil, Tetlock, and Mellers, supra note 41, at 298.

[46]This characterization finds support in the literature: "In those situations where an accountable individual knows what response the evaluator will find acceptable (unambiguous), there is a tendency to conform to that standard (the "acceptability heuristic") in order to win approval. When the evaluator's standard is unknown (ambiguous), however, simple conformity is obviously no longer an option. Assuming that the judge or decision maker still cares about winning approval, his next best option will be to find the most defensible course of action available." K. Siegel-Jacobs and J. F. Yates, "Effects of Procedural and Outcome Accountability on Judgment Quality", 65 *Organizational Behavior and Human Decision Processes* 1, 1996, at 2. Accountability could in the abstract result in more reasoned decision-making, but that's where doing so gets you a payoff. Here, there are high stakes, the decisions are not reversible, and there is no accepted way of proceeding. See, e.g., Tetlock and Mellers, "Structuring Accountability Systems in Organizations", supra note 42.

[47] Megan Potter, Effects of Process vs. Outcome Accountability, Responsibility, and Identifiability on Solution Quality, Master's Thesis, Psychology, University of Nebraska, 1998, available at

As noted above, an excellent and wholly intuitive example of justificatory strategies relating to process is 'defensive medicine,' in which doctors use accepted processes to insulate themselves against the consequences of possible bad outcomes. A recent article, describing a particular case, explained the concept:

> "Physicians make judgment calls every day. Clinical information is often imperfect, and even when it is clear, the scientific evidence about how to use it may not be. In addition, forces that sometimes run counter to a patient's best interest can affect decision making. This case highlights how physicians' personal interests in avoiding malpractice liability can influence how they manage clinical uncertainty."
>
> "Liability concerns can also loom large in decisions about ordering tests because malpractice claims for missed or delayed diagnoses are common. The legal standard of care reflects what is reasonable under the circumstances, and [the patient's] physicians should not be held liable for a missed diagnosis if their decision not to admit her reflected sound clinical judgment. However, reasonableness is often determined by what is customarily done in similar circumstances. In practice, then, malpractice law could create a vicious circle for physicians: the more their colleagues practice defensive medicine, the more legally vulnerable they become if they do not."[48]

This description fits our context quite well except that those to whom the actors are accountable are not just, and indeed, are often not, courts. They are other market actors, including their financiers and their peers. What is determined to be acceptable is thus also not what is 'legally' acceptable, but instead, what is considered to be acceptable in the relevant community. (While this is beyond our scope, we suspect that doctors are also accountable to and within their communities, and that norms, not just legal standards, also play a significant role.)

Accountability in corporate governance is in the first instance outcome accountability. That is, if there is a good outcome, the process will probably not be second-guessed. Accountability works similarly in finance – an investment decision that pays off will not be second guessed even if the process by which it was made was deeply flawed or even random.

But what if there is a bad outcome, or the outcome is not unambiguously good? In such cases, the actor may point to her process to justify her decision. Consider a

---

https://digitalcommons.unomaha.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1156&context=studentwork.

[48] Kachalia and Mello, supra note 2.

manager's choice to hire someone from a culture different from the culture of others in the organization. If the would-be employee has top mainstream credentials, even if the person is not successful at the job, the manager can point to the mainstream credentials as a justification for her decision.[49] Or, in the finance sphere, the money manager can point to rating agencies' top ratings for the securities the manager purchased. These strategies, abiding by accepted norms or using an accepted process, come under the rubric of "process accountability." We would argue that some of that is at issue as well, both as to managers and as to shareholder activists. Indeed, notwithstanding the activists' supposed individualized plans for particular companies, there does seem to be an 'activist playbook;' the 'playbook' may also be used by managers who try to pre-empt activist campaigns.[50] The playbook is not just helpful for process accountability. Insofar as some of what is in the playbook yields quick cash, either for the company, the shareholders, or both, it may seem that there has been a good outcome as well. (Of course, as is broadly recognized, we can't know if not pursuing the quick cash would have yielded a better outcome.)

### ***How Uncertainty Can Yield Agency Costs***

Because good outcomes are never assured, a corporate actor will want, ex ante, to formulate a justification in the event of a bad outcome. Bad outcomes may, or may not, be the result of bad behavior; the actor might simply have been unlucky. To avoid being judged unfavorably – and perhaps fired – by her principal in such situations, an agent will tend to make the decision that is easier to justify if it turns out badly, even if the decision is not the best one for the principal. Proceeding in this manner is an agency cost to the extent that the principal's welfare fails to be maximized because of the agent's self-interested behavior in protecting her downside. These agency costs differ in important respects from traditional agency costs (such as those stemming from shirking, misappropriation, or empire building). Accountability is helpful in reducing traditional agency costs; agents, knowing that they will suffer consequences for engaging in the behavior at issue, will be less inclined to do so, such that monitoring and bonding costs of minimizing such behavior are reduced.[51] By contrast, the agency costs stemming from justification-motivated decisions are exacerbated by accountability: the more accountability, the more agents will make

---

[49] See C. A. Hill, "Justification Norms Under Uncertainty: A Preliminary Inquiry", 17 *Connecticut Insurance Law Journal* 27, 2010.

[50] See note 24, supra.

[51] See Jensen and Meckling, supra note 9, at 308.

decisions with justification in mind, diverging more from what would be best for the principal, thus increasing the overall cost ("residual loss") to the principal.[52]

Which set of agency costs is likely to be bigger depends on context: decision-making motivated by an anticipated need for justification is sometimes efficient, sometimes not. When uncertainty is low, agents' decisions can, and not infrequently do, represent the agent's assessment of the best decision for her principal as well as being readily justifiable in the event of a bad outcome; the decision in such cases does not reflect a justification cost. Stated differently, accepted ways of proceeding, supported by considerable information as to similar situations, exist. By contrast, in the presence of high uncertainty, choosing what is justifiable may result in justification costs since what is justifiable – relying on what others are doing, what is generally done, or what should pay off quickly—may not be what the agent would choose if her only aim was to achieve value for the principal.

Both traditional and justificatory types of agency costs are affected by institutional ownership, albeit in opposite directions. Institutional ownership decreases traditional agency costs by reducing atomistic shareholders' monitoring costs, particularly in cases of underperformance when activist shareholder engagement itself activates institutional investors' voice.[53] But institutional investors can increase the agency costs of justification. They are a constituency to which management is, and believes itself to be, accountable. Moreover, institutional investors are themselves agents, accountable to the people giving them money to invest. Institutional investors will wish to avoid outflows from their funds, since they are compensated as a percentage of their funds' assets. They will thus side with managers who seek to protect their downsides by making justification-motivated decisions. Such decisions

---

[52] Our point may be articulated within the realm of agency theory. Jensen and Meckling, ibid., define agency cost as the sum of 'monitoring costs', 'bonding costs', and 'residual loss'. The latter is the cost of the "divergence between the agent's decision and those decisions which would maximize the welfare of the principal." While accountability reduces monitoring costs and bonding costs, it does not necessarily reduce the residual loss. On the contrary, we argue that the residual loss may increase by a larger amount as a result of justification-motivated decisions. This problem is akin to the problem of over-monitoring discussed in the economic literature on principal-agent problems. Monitoring, particularly by large shareholders, constrains managers' ability to extract private benefits, but it may be excessive insofar as it undermines managerial discretion, which in turn may result in suboptimal choices. See M. Burkart, D. Gromb, and F. Panunzi, "Large Shareholders, Monitoring, and the Value of the Firm", 112 *Quarterly Journal of Economics* 693, 1997. We take the over-monitoring theory one step further by making justification costs explicit (albeit without formally modelling them). This allows us to argue that accountability may be excessive irrespective of the optimal ownership structure – i.e., justification costs may be higher than traditional agency costs both in dispersed and in concentrated ownership structures. In both contexts – we claim – Control Enhancing Mechanisms may ameliorate the balance between justification costs and traditional agency costs. See infra, text accompanying notes 251-261.

[53] R. J. Gilson and J. N. Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights", 113 *Columbia Law Review* 863, 2013.

should allow both management and the investment fund to attribute underperformance to 'others' or 'bad luck'.

***Assessing Uncertainty***

Contrast a long-standing, oligopolistic business competing based on established patterns (such as smartphones today or car manufacturing before driverless cars) with a business involving cutting-edge technology and the creation of new markets (e.g. car manufacturing today or telecommunications before the smartphone). Both businesses will need to innovate to survive, but a) the former will face tougher competition and need to react faster than the latter; b) the former will face less uncertainty than the latter; and c) for both businesses, the degree of uncertainty exposure will change with time.[54]

While a company's decision-making is always undertaken under conditions of uncertainty, the degree of uncertainty varies between companies and, within the same company, over time. For example, at this juncture, the innovation cycle in the telecommunications industry is short. Companies need to determine what works and what does not within a few months, if not weeks, in order to react promptly to competition. Because feedback is short-term, uncertainty is thereby limited. Note how different the same industry looked only twenty years ago. The innovation cycle was long, and the winners in the competitive arena could arise from virtually anywhere. Uncertainty was very high. Contrast this example with the automotive industry. Few would have characterized this business as uncertain twenty years ago. Producers had to keep up with short innovation cycles in safety and engine efficiency, or disappear. Fast-forward to today. Short of the fact that people will still need cars in the next decade, little is known about how these will be operated and powered. Uncertainty is thus high.

Uncertainty varies greatly across businesses and over time, making the efficient response to the problem of allocation of power in corporate governance vary as well. In contexts of low uncertainty, that managers have to justify their actions to investors is beneficial. One of the functions of accountability is to alert management to mistakes. Bad managers are not only those who shirk or take advantage of shareholders, including those who don't examine their own actions or leadership sufficiently critically.

Our broader approach to agency costs echoes a point made by Albert Hirschman in 1970 that when competition is vigorous, voice is preferable to exit because it alerts

[54] In this regard, Knight notes that entrepreneurs have roles not only in new enterprises, but also in established enterprises that are ripe for change. Knight, supra note 12, at 333-334.

management before it is too late.[55] On this perspective, the concentration of institutional ownership supporting the business model of shareholder activists[56] is beneficial because activism and the threat thereof can, in addition to discouraging self-interested behavior, timely alert management that they are being slow in reacting to the company's competitors' moves. This is very much the story of Third Point's Sotheby's engagement discussed above. Indeed, the empirical evidence reveals that short-term feedback, including in the form of selloff by short-term investors, is often beneficial.[57]

In business contexts where uncertainty is high, however, reliance on short-term feedback may be counterproductive. Uncertainty means that the future is not predictable even within a broad range, because there is no reason to suppose that the future will be like the past. It might be the same, similar, different, or even radically different.[58]

Building on the work of John Maynard Keynes and Frank Knight, we distinguish two different ways of proceeding in the face of uncertainty, that of "entrepreneurs," and that of "financiers."[59] (Entrepreneurs can, of course, be managers or those financing business activities; the same is true of financiers. The terminology indicates an approach to decisions, not a business role.) Both Keynes and Knight consider entrepreneurship to be an approach to uncertainty that is based on intuition rather than on probability distributions or other mechanical or otherwise-conventional

---

[55] A. O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Harvard University Press, 1970), 33, 35-37.

[56] See infra, text accompanying notes 75-76.

[57] Giannetti & Yu, supra note 34. That being said, there are such things as "death spirals," where short-term feedback turns a perhaps-surmountable situation into, yes, a death spiral. This was much discussed around the time of Enron, where the feedback was in the form of credit downgrades that had carryover and recursive effects. It is hard to know how to balance all the relevant interests in such cases and, as significantly, how to tell the short-term problems from long-term ones. I discuss this issue in C. A. Hill, "Rating Agencies Behaving Badly: The Case of Enron", 35 *Connecticut Law Review* 1145, 2003.

[58] A. M. Pacces, *The Future in Law and Finance* (Eleven International Publishing, 2013). See also supra, text accompanying notes 35-37. According to Knight "change according to known law (whether or not we call it change) does not give rise to uncertainty." Knight, supra note 12, at 313. Note that the phrase "the future is (or is not) like the past" is shorthand, simplifying complexities that can largely be ignored for purposes of our analysis. The future is always in some sense significantly similar to, and significantly different from, the past. Descriptions are not mechanical or neutral: reasonable people might disagree as to whether a particular business outcome showed that strategy x 'didn't always work' or 'wasn't properly attempted,' for instance. There might be disagreement in characterizing the outcome as well. One of us explores this issue further in the context of contract negotiations and contract provisions in C. A. Hill, "Why Are Contracts Written in Legalese", 77 *Chicago Kent Law Review* 59, 2002.

[59] See in particular Keynes, *General Theory of Employment,* supra note 14, Chapter 12, pp. 147-164, distinguishing between "speculation", which motivates finance, and "enterprise," which determines real investment.

methods.[60] The mark of true entrepreneurship is having a "free hand" to deal with uncertainty.[61] Thus, an entrepreneur's approach will by definition not be conventional. [62] Moreover, her performance will be harder to monitor, since standard milestones may not capture her interim achievements.

By contrast, the financier's approach will be conventional, again, treating uncertainty like risk, implicitly assuming the future will not be radically different from the past and that decisions can be made on the basis of established probability distributions and other mechanical techniques. Indeed, the financier's approach, treating uncertainty like risk, is a common reaction to uncertainty.[63]

Investors' insistence on justification undermines entrepreneurship in two ways. First, management will be motivated to choose more conventional courses of action, which can be more readily justified in the event of a bad outcome. And those conventional courses of action will be less good as guides to what they should do. Second, management will be motivated to choose actions that, based on existing conventional models, are expected to deliver result within the interval in which investors evaluate performance. The shorter this interval is, the stronger the management's incentive to 'play it safe.' Inasmuch as management choice departs from what their best judgment would be in the absence of justification (which, again, is more likely the higher the degree of uncertainty faced by the particular company), the frustration of entrepreneurship also lowers shareholders' expected returns and therefore constitutes an agency cost.[64]

The degree of uncertainty varies, particularly as a function of the kind of innovation at issue.[65] For example, mature businesses normally engage in incremental innovation. Incremental innovations imply improvements on *existing* (not new) markets or technology. The outcomes of incremental innovation are somewhat predictable albeit within a broad range. By contrast, discontinuous and radical innovations entail a much higher degree of uncertainty. Discontinuous innovation

---

[60] See Knight, supra note 12, at 232. Keynes famously characterized this intuition as "animal spirits." Keynes, *General Theory of Employment,* supra note 14, Ch. 12, VII, 161-163.

[61] Knight, supra note 12, at 361.

[62] Ibid.

[63] Pacces, "Illiquidity and Financial Crisis", supra note 38. We elaborate on the consequence of this approach on speculation and arbitrage in the text accompanying notes 111-113.

[64] See text accompanying notes 51-52.

[65] For a classification of innovations, see R. Garcia and R. Calantone, "A Critical Look at Technological Innovation Typology and Innovativeness Terminology: A Literature Review", 19 *Journal of Product Innovation Management* 110, 120-124, 2002.

involves either a new market or a new technology, whereas radical innovation involves both. There is also disruptive innovation, which commonly has a significant period of underperformance until one or more existing markets is disrupted. The trajectory is inherently unpredictable.[66]

A context frequently discussed in the manager vs. activist (and hostile acquirer) debates is research and development (R&D) spending. Keeping such spending low may or may not be best for the principal, but it is often good for the agent. A larger investment might have been hard to justify if it didn't produce good results quickly enough. Moreover, in the short term, the reduction in current spending improves the company's financial appearance. Thus, a manager might be tempted to minimize R&D spending, whether or not doing so is good for the company.

Because the benefits of R&D spending are difficult to measure, assessing whether such spending is good for the company is difficult. Empirical evidence suggests that the reduction of R&D input does not necessarily undermine measurable R&D output.[67] However, the studies typically use patents or patent citation counts as measures. This does not necessarily capture actual R&D output.[68] It does it well for certain types of innovation, but less well for others. Specifically, the benefits of R&D spending are easier to measure for companies engaging in incremental innovation than for those engaging in other types of innovation, especially radical and disruptive innovation. Where a company is engaged in incremental innovation, there is less uncertainty, such that patent counts and citations are good proxies for R&D output. Moreover, in the realm of incremental innovation, competition is usually fierce, making the ability to maintain output levels at the lowest cost key for survival. But reducing R&D expenditures may be inefficient for other companies, even if the reductions do not seem to reduce measurable R&D output. Because the value of discontinuous and radical innovation is hard to measure, patent counts and citations may well underestimate it. Moreover, especially in the case of disruptive innovation, the initial value of innovation may appear even negative in the short term.[69] In sum, cutting R&D expenditures may be tempting to managers making justification-motivated decisions, and doing so may represent a justification cost. Finally and notably, in addition to the agency costs of decisions regarding reductions of R&D

---

[66] Christensen, supra note 16.

[67] A. Brav et al., "How Does Hedge Fund Activism Reshape Corporate Innovation?", *Journal of Financial Economics*, forthcoming 2018, https://doi.org/10.1016/j.jfineco.2018.06.012.

[68] Coffee & Palia, supra note 30, at 575-576.

[69] See C. M. Christensen, M. E. Raynor, and R. McDonald, "What Is Disruptive Innovation?", *Harvard Business Review*, Dec. 2015, available at https://hbr.org/2015/12/what-is-disruptive-innovation.

expenditures, there are potentially social costs as well – a drug not produced, the beneficial health results not achieved, perhaps an invention postponed by a decade or even forever which might have spurred other inventions.

A society with insufficient entrepreneurship faces several costs.[70] As noted above, the most obvious and commonly remarked-upon costs relate to the diminished entrepreneurship itself – the research stopped early, the discovery not made, the products and services not produced. Other familiar costs are those that have been bemoaned in the context of highly-leveraged transactions – the loss of flexibility from high debt loads, the societal costs of disruption given big cuts in payroll to meet debt service payments, the costs if the business fails on grounds of these high debt loads, and so on.[71] Finally, albeit controversially, another cost could be secular stagnation, a slowdown of the economy resulting from lesser levels of innovation.[72]

This takes familiar arguments about the so-called 'evils' encouraged by shareholder activists, notably including short-termism, one step further. Short-term economies from selling divisions, and making capital repurchases or paying dividends, and even borrowing money to do so, as well as reducing payrolls, may have a good effect on the broader economy if the capital is better deployed elsewhere. But they may not. How would we know if capital is better deployed elsewhere? There may be an inherent bias towards short-termism insofar as quicker returns on capital are more readily justifiable than uncertain and remote payoffs.[73] Public companies may thus become short-termist (or have to go private) even when doing so is inefficient for them. Moreover, there are social costs if innovation and entrepreneurial activity are unduly chilled.

Arguments about short vs. long-termism embed a judgment about what counts as being short term. What determines how long a (corporate or fund) manager might

[70] See Knight, supra note 12, at 347-375. See also Keynes, *General Theory of Employment,* supra note 14, Ch. 12, VII, 161-162 ("animal spirits").

[71] S. N. Kaplan and P. Strömberg, "Leveraged Buyouts and Private Equity", 22 *Journal of Economic Perspectives* 1, 2008.

[72] See L. H. Summers, "Demand Side Secular Stagnation", 105 *American Economic Review* 60, 2015. One of the objections to the secular stagnation hypothesis is that it does not take entrepreneurship and innovation fully into account. See Philippe Aghion, "Entrepreneurship and Growth: Lessons from an Intellectual Journey", 48 *Small Business Economics* 9, 2017.

[73] Note how this could be easily reversed depending on market sentiment. Specifically, the conventional wisdom could be that long term bets on future returns, however uncertain and far in the future, are more justifiable. This happened not so long ago, for certain kinds of business, such as Internet companies at the end of the last century.

be given to show results? The standard short-termist critique, and indeed, our thesis, relies on managers not being given enough time when they claim they need more time. How much time are they given, and why that amount of time? Outcome and process accountability are intertwined here – the better process does not just justify a bad outcome; it also justifies a longer wait for a good outcome. Moreover, certain sorts of processes are encouraged – that is, deemed to be justifiable because they seem to pay off quickly. But the determination of whether there has been a good outcome is more complicated than it might seem. For instance, doing 'just in time' staffing to cut costs might seem to save money, but a more complicated computation could take into account higher employee turnover, and perhaps, costs the company later incurs in the form of reduced business or greater regulatory scrutiny (or even lawsuits) arising from bad publicity, higher medical costs for the employees, and so on. Much follows from this, but for purposes of our argument, it bolsters the case for the solution we suggest in Section 4 – that shareholders and managers should be able to, together, define what counts as an acceptable time horizon.

In sum, the foregoing identifies social costs as well as agency costs of decision-making motivated by justification. We do not suggest that the classic concerns regarding traditional agency costs are nonexistent, or that close monitoring, which may embed and encourage the use of conventional metrics, is never appropriate. There are at least two reasons why conventional decision-making is often the best individuals can do. First, uncertainty of the future varies with context, being higher in some situations than in others. Particularly when uncertainty is *not* high – as in routine businesses having decades of history and long time series from which to extrapolate – conventional decision-making may be the best possible way to deal with the future. Indeed, where uncertainty is low, doing what others do, which may resemble herding, may be both individually and collectively appropriate. Second, conventional justifications are useful because they reduce the cost of monitoring agents and policymakers. Particularly in situations where conflicts of interest are high – as in countries with low investor protection and/or high levels of corruption – having more accountable managers and policymakers may be worth the inflexibility and consequent discouragement of entrepreneurship stemming from more conventional decision-making. But, as we explained above, we think there are situations where managers should be given the opportunity to contract for more leeway. In Section 4, we explain what form the leeway would take.

### *A More Nuanced Picture of Activism*

Everyone involved in the corporate governance sphere is to some extent seeking buy-in, including managers as they guide their companies, but the need is particularly acute for shareholder activists. After all, such activists generally do not seek to take control;[74] they buy relatively small (but significant) stakes in a company and use various tactics to exert pressure. Their business model is for the company to adopt their agenda and thus provide them with a profit.[75] To get the company to adopt their agenda, they need other shareholders' support.[76] This should affect what they propose, and whether what they propose is successful.

How does this constraint affect shareholder activist engagement campaigns? It is difficult to know. Certainly, institutional investors must be cultivated. What does that take? One recent strain is an increasing, at least rhetorical, emphasis on longer time horizons and on social purposes, which generally are long-term.[77] As stated in a 2017 review of activist investing: "All activists will seek to portray themselves as keenly interested in environmental, social, and governance (ESG) issues. At a minimum, they will talk more about the long-term consequences of their involvement."[78] Patience may fail, though: underperformance, though, will spur some sense of opportunity- and urgency. Indeed, the impetus to 'do something' about underperformance is part

[74] See, e.g., C. Nathan, "Debunking Myths about Activist Investors", *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), March 15, 2013 ("Today, activist investors rarely seek equity stakes in target companies above 10%[.]").That being said, activists do occasionally work in tandem with private equity firms to, together, mount a takeover attempt. A recent well-known example is Pershing Square's attempt, with Valeant, to take over Allergan. A. Gara, "Bill Ackman and Valeant Settle Allergan Insider Trading Lawsuit for $290 Million", *Forbes*, Dec. 30, 2017, available at https://www.forbes.com/sites/antoinegara/2017/12/30/bill-ackman-and-valeant-settle-allergan-insider-trading-lawsuit-for-290-million/#7d134e731f32.

[75] While their aim is to have their agenda adopted, they can also take into account that even if the company does not adopt their agenda, they could profit from heightened interest in the company spurred by their interest, or even by acquisitions prompted by rivals or those invited by management. But see M. Becht et al., "Returns to Hedge Fund Activism: An International Study, 30 *Review of Financial Studies* 2933, 2017, at 2954 (showing that the returns on engagements with multiple outcomes involving a takeover are roughly double to the returns on engagements involving only a takeover).

[76] Gilson and Gordon, supra note 53.

[77] "A Sense of Purpose", annual letter from BlackRock CEO Larry Fink to major corporate CEOs, 2018, available at https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter; see also Berman, supra note 31; David Benoit, "Activist Investor Takes a Page From Greenpeace, Pushing Companies for Change", *Wall Street Journal*, March 19, 2017; Trian Fund Management, Environmental, Social and Governance Policy Statement, June 2017, available at https://trianpartners.com/content/uploads/2017/06/Trian_ESG_Policy_Statement_-_June_2017.pdf.

[78] Activist Insight, *The Activist Investing Annual Review 2018*, at 7, available at https://www.srz.com/images/content/1/5/v2/155375/The-Activist-Investing-Annual-Review-2018-HiRes.pdf.

of the story of justification-motivated decision-making, by corporate managers, institutional investors, and activist investors.

Of the institutional investors, those who are most often pivotal in an activist's campaign are index funds.[79] Index funds do not have discretion to enter or exit the investment in a particular company, since they need to be tracking the relevant index. Thus, they are long-term shareholders. But is their perspective a long-term perspective? First, they are the opposite of activist shareholders themselves—they are passive investors. But they are not passive shareholders.[80] Regulation on both sides of the Atlantic requires them to disclose their voting policies,[81] which indirectly compels them to vote. While voting decisions could be outsourced entirely to proxy advisors, such as Institutional Shareholder Services (ISS), empirical studies reveal that the large index fund managers – who are often crucial in an activist's campaign – do not necessarily vote in accordance with ISS recommendations.[82] This might seem puzzling insofar as index funds' business model consists in tracking a stock index at the lowest possible cost. Informed voting, on the contrary, is expensive and benefits every other investor in the particular company. There is, however, one dimension of voting which is not chilled by this free riding problem: low-cost policies that can be generalized across portfolio companies, such as policies against takeover defenses or Control-Enhancing Mechanisms (CEMs). Because such policies, on average, help address underperformance, they are worthwhile for index funds insofar, again, as the funds cannot exit underperforming investments.[83] But they are not based on a particular company's situation. Thus, campaigns seeking to address defects in

---

[79] Pacces, "Exit, Voice and Loyalty", supra note 6, at 208-9.

[80] I. R. Appel, T. A. Gormley, and D. B. Keim, "Passive Investors, Not Passive Owners", 121 *Journal of Financial Economics* 111, forthcoming 2019, earlier version available at https://irrcinstitute.org/wp-content/uploads/2015/12/Passive-Investor-Paper.pdf.

[81] By mandating the disclosure of institutional investors' voting, U.S. legislation effectively compels them to vote in order to avoid embarrassment. See E. B. Rock, "Institutional Investors in Corporate Governance", University of Pennsylvania Faculty Working Paper No. 1458, available at https://scholarship.law.upenn.edu/faculty_scholarship/1458/. A similar outcome it to be expected in the European Union after the entry into force of the revised Shareholder Rights Directive (Directive EU 2017/828 of 17 May 2017) in June 2019. See Pacces, "Shareholder Activism in the CMU", supra note 24, at 522.

[82] There is considerable disagreement as to how much of investors' votes ISS and other proxy advisors, notably Glass Lewis, effectively control—that is, how much influence those recommendations have, with some commentators arguing that the advisors' influence has been exaggerated. See generally S. Choi, J. Fisch, and M. Kahan, "The Power of Proxy Advisors: Myth or Reality?", 59 *Emory Law Journal* 869, 2010; P. Iliev and M. Lowry, "Are Mutual Funds Active Voters?", 28 *Review of Financial Studies* 446, 2015.

[83] J. Fisch, A. Hamdani, and S. Davidoff Solomon, "Passive Investors", Preliminary Draft, April 13, 2018, available at http://www.law.nyu.edu/sites/default/files/upload_documents/Steven%20Davidoff-Solomon%20Passive%20Investors%20april%2013%20clean%20copy.pdf.

governance as compared with 'standard' norms, or underperformance, are apt to be those that gain index funds' support.

Some commentators have argued that institutional investors provide a reliable screening of activists' proposals.[84] Others have argued the opposite, namely that the procedure determining activism's success is biased towards short-termism and social costs.[85] We disagree with both of these views. Activists teaming up with index funds expected to vote in a standardized fashion does not necessarily lead to short-termism, nor does it lead unambiguously to a good or a bad outcome. For instance, this combination (and its credible threat) constrains the ability of management to expropriate shareholders, receive excessive compensation, or engage in empire-building.[86] However, the management of companies that can be targeted by activist shareholders will also tend to make conventional choices, choices that are justifiable to investors, regardless of whether these choices reflect the managers' best judgment as to what would be good for their companies.

A big question is thus the extent to which both activists and institutional investors will continue emphasizing one-size-fits-all solutions; certainly, forces of justification favor such solutions, as does, for institutional investors, the cost incentive to have one generally applicable approach rather than approaches specifically tailored to particular portfolio companies in what may be an enormous portfolio. As to the latter point, consider that the largest asset managers worldwide – Blackrock, Vanguard, and State Street – manage, collectively, some 11 trillion US dollars of financial assets. They are the largest shareholders in the majority of public corporations worldwide, including owning 90% of the S&P 500 (that is, 90% of the total shares of the companies on the S&P 500).[87] Their analysts cannot monitor all portfolio companies on an individualized basis, although they could decide to make long-term contractual arrangements (of the sort we propose, which, while customized as to a few variables, such as the length of the arrangement, nevertheless fall within a few circumscribed categories) with some of them. We think they should do so, and should not accede to

[84] Gilson & Gordon, supra note 53. See also W.-G. Ringe, "Shareholder Activism: A Renaissance", in J. N. Gordon and W.-G. Ringe, eds., *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press, 2018).

[85] J. C. Coffee, Jr., "The Agency Costs of Activism: Information Leakage, Thwarted Majorities, and the Public Morality", ECGI Law Working Paper No. 373/2017, November 2017, available at https://ecgi.global/sites/default/files/working_papers/documents/finalcoffee.pdf.

[86] Pacces, "Exit, Voice and Loyalty", supra note 6, at 210.

[87] See J. Fichtner and E. Heemskerk, "These 3 Firms Own Corporate America", *Business Insider*, May 10, 2017, available at http://www.businessinsider.com/american-corporation-big-three-firms-2017-5. Blackrock, Vanguard, and State Street have corporate governance offices made of respectively 31, 20, and 11 analysts. See "BlackRock, Vanguard, and State Street Bulk Up Governance Staff", *Financial Times*, Jan. 28, 2017, available at https://www.ft.com/content/657b243c-e492-11e6-9645-c9357a75844a.

the push by "governance activists" to pressure companies to adopt, across the board, what the governance activists call "good" governance practices. These practices effectively give managers less power, and shareholders more power, and notably include discouraging the use of staggered boards as well as poison pills.

In sum, there is voluminous literature, full consideration of which is beyond our scope, as to how activists' need to cultivate institutional investors affects what ideas they propose and what proposals succeed.[88] It might have been thought that insofar as activists are considered "short term," their need to cultivate more "long term" investors would limit short-termism and thus, on this view, the associated societal and perhaps agency costs of short-termism.[89] We have two objections. First, as we have argued, we do not accept the 'activists are/are not clearly short-termist in problematic ways' framing. Second, and more importantly, the foregoing demonstrates that the effects of activist shareholders' need to cultivate institutional investors are complex – and that there is no reason to suppose that the effects include a reduction in agency costs associated with justification-motivated decision-making.

### *Application to Europe: The Role of Controlling Shareholders*

The foregoing has largely assumed the U.S. paradigm, in which the battle is between managers, who have control, and shareholders, who may sometimes acquire fairly large stakes, but in general, not controlling stakes. Certainly, very few large U.S. corporations have controlling shareholders. In continental Europe, by contrast, a majority of listed companies have controlling shareholders who by definition control the board. This implies a different set of agency problems. In the presence of a controlling shareholder, the conflict of interest is not between management and shareholders, but between the controlling and minority shareholders.[90] One might think, though, that the problem we are concerned with—the need to justify –would

---

[88] The determination is complex. Whatever the activists are suggesting, their ultimate success should turn on what shareholders other than them convey that they favor. This may moderate activist shareholders' ability to yield short-termism unless the support they receive (or expect to receive) stems from short-termist institutional investors. It should be noted that investors' time horizons for their investments are not dispositive in this regard: long-term investors do not necessarily support long-term policies and short-term investors do not necessarily support short-term policies. A. Edmans and C. G. Holderness, "Chapter 8—Blockholders: A Survey of Theory and Evidence", in B. Hermalin and M. Weisbach, eds., *The Handbook of the Economics of Corporate Governance*, Vol. 1 (North-Holland, 2017).

[89] See particularly Ringe, supra note 84, 418-422.

[90] See R. Kraakman et al., *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 3rd ed. (Oxford University Press, 2016), 79-89.

not be present, insofar as the controllers control, and hence need not face credible challenges from activist shareholders. But even controlling shareholders and their companies face justification problems, as we explain below.

Whether controlling shareholders of a company need to justify to other shareholders of the company their choices vis-a-vis the company depends on the company's ownership structure and the controlling shareholders' ability to command voting power beyond that associated with their ownership. Whereas the former largely depends on the controlling shareholder's wealth and choices concerning the firm's size, the latter depends on whether, and to what extent, the law allows for so-called control-enhancing mechanisms. Control-Enhancing Mechanisms (CEMs), such as dual-class shares and loyalty shares, allow for departures from the one-share one-vote (1S1V) principle, which we discuss in Section 3 and expand on in Section 4. Indeed, CEMs are at the core of our proposal to reduce justification-motivated decision-making where such decision-making is inefficient.

According to recent research,[91] on average 44% of listed companies in the world have a controlling shareholder. The U.S. and the UK, having, respectively, 25% and 17% controlled companies, are substantially below the world average. By contrast, about two-thirds of French, German, and Italian listed companies have a controlling shareholder, whereas Sweden and the Netherlands are more in line with the world average. This roughly confirms previous findings:[92] apart from the U.S. and the UK, in most countries a substantial portion of listed companies, if not a majority of them, has a controlling shareholder.[93]

A global study of corporate ownership reveals not only that controlling shareholders are more common in Europe than in the Anglo-Saxon world, but also that dispersed ownership as described in Berle & Means is actually quite rare.[94] Worldwide, 91% of listed companies have at least one blockholder with a stake larger than 5%.[95] This

[91] G. Aminadav and E. Papaioannou, "Corporate Control Around the World", NBER Working Paper No. 23010, December 2016, available at http://www.nber.org/papers/w23010.

[92] Previous literature used cut-offs (of 25%, 30% or 50%, which are somewhat arbitrary) to determine whether a company had a controlling shareholders. By contrast, Aminadav and Papaioannou, ibid., used power indices to estimate the likelihood of the largest shareholder to win a voting contest.

[93] R. LaPorta, F. Lopez-de-Silanes, and A. Shleifer, "Corporate Ownership Around the World", NBER Working Paper No. 6625, June 1998, available at http://www.nber.org/papers/w6625.

[94] A. A. Berle and G. Means, *The Modern Corporation and Private Property* (Transaction Publishers, 1932).

[95] Aminadav and Papaioannou, supra note 91.

percentage is even higher (96%) in the U.S.[96] The presence of such blockholders gives shareholder activists the chance to engage the management of a listed company to the extent that they can persuade institutional blockholders to vote against the management.[97]

Even where there are controlling shareholders, a coalition of minority shareholders can often outvote them so long as company law or the charter requires a supermajority. Thus, controlling shareholders may be insulated from hostile takeovers, but not from hedge fund activism.[98] Second, 47% of public companies around the world do *not* have technically a controlling shareholder but *do* have one or more blockholders. The more blockholders there are in a corporation, the higher the chance for activists to assemble enough support to mount a successful campaign against the management. It follows that shareholder activism can target many companies worldwide, including companies with controlling shareholders. Indeed, there are increasing numbers of activism campaigns outside the U.S. and U.K. Particularly in continental Europe,[99] shareholder activism correlates with the presence of blockholders such as institutional investors, especially foreign ones, whether or not there are controlling shareholders.[100]

---

[96] C. G. Holderness, "Blockholders Are More Common in the United States Than You Might Think", 22 *Journal of Applied Corporate Finance* 75, 2010. Ownership is much more dispersed in the UK, though. See J. Franks and C. Mayer, "Chapter 10—Evolution of Ownership and Control Around the World: The Changing Face of Capitalism", in B. Hermalin and M. Weisbach, eds., *The Handbook of the Economics of Corporate Governance*, Vol. 1 (North-Holland, 2017), at 724.

[97] Gilson and Gordon, supra note 53.

[98] Ringe (2018), supra note 84, 399, makes a related point in the context of corporate governance in Germany.

[99] Activism is booming in Europe. More than 100 companies were targets of activist campaigns in the period between January – September 2017. See Activist Insight, *Activist Investing in Europe: A Special Report*, October 2017, available at https://www.activistinsight.com/wp-content/uploads/2017/02/ActivistInvestingInEuropeSpecialReport.pdf?x83756.

[100] See, e.g., T. Poulsen, T. Strand, and S. Thomsen, "Voting Power and Shareholder Activism: A Study of Swedish Shareholder Meetings", 18 *Corporate Governance* 329, 2010; W. Bessler, W. Drobetz, and J. Holler, "The Returns to Hedge Fund Activism in Germany", 21 *European Financial Management* 106, 2013; M. Belcredi and L. Enriques, "Chapter 18—Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: The Case of Italy", in J. G. Hill and R. S. Thomas, eds., *Research Handbook on Shareholder Power* (Edward Elgar, 2015), 383. Regarding the changes of ownership structure supporting the increase in shareholder activism, for instance in Germany, see W.-G. Ringe, "Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG", 63 *American Journal of Comparative Law* 493, 2015 (documenting, among other factors, the decreasing relevance of bank ownership and controlling shareholders in the largest German listed companies); for Sweden, see P. Lekvall, ed., *The Nordic Corporate Governance Model* (SNS Förlag, 2014), 47-48.

Although activists may more easily prevail in the absence of controlling shareholders, even controlling shareholders cannot always ignore activists. First, in many European jurisdictions, minority shareholders have statutory rights such that they can't simply be outvoted and ignored. In Italy and Spain, for instance, minority shareholders have the right to appoint their own directors. The charters of some U.S. companies with a controlling shareholder include similar provisions, which have been used by activist shareholders.[101] A jurisdiction may have other provisions that effectively empower minority shareholders, thus enabling shareholder activism in such a jurisdiction even in companies with controlling shareholders.[102] Second, many controlling shareholders are not actually majority shareholders. For instance, a recent study finds that less than half of the listed companies in France, Germany and Italy have a majority shareholder.[103] Given that about two thirds of publicly held companies in these countries have been recently categorized as controlled,[104] we can infer that around 17% of controlling shareholders, on average, can in principle be outvoted. The more the minority blockholders are institutional investors, the more likely outvoting controlling shareholders becomes. In conclusion, shareholder activists can and do engage with companies having a controlling shareholder.

In Sweden, for instance, two so-called "spheres" – one of which is a fund owned by the most influential Swedish family, the Wallenbergs – traditionally control over half of the Swedish stock market capitalization.[105] Both spheres were successfully challenged by the local activist hedge fund Cevian in recent years. The Swedish

[101] K. Kastiel, "Against All Odds: Hedge Fund Activism in Controlled Companies", 2016 *Columbia Business Law Review* 60, 2016.

[102] For instance, in Sweden, much of shareholder activism takes place through the nomination committee. This is not a board committee, but a shareholder committee comprising the 3 to 5 largest shareholders of a listed company. Every year, the nomination committee makes a proposal as to who to appoint to the board, which is usually rubberstamped by the general meeting. At least one member of the nomination committee must be independent from the controlling shareholder. The nomination committee normally decides unanimously. Note that none of this is legally binding. The nomination committee is provided for by the Corporate Governance Code, which formally could be opted out of (save that virtually no company does it). Moreover, the general meeting could appoint other candidates to the board, but this does not happen in practice. P. Lekvall, ed., *The Nordic Corporate Governance Model* (SNS Förlag, 2014). As a result, shareholder activists conduct their campaigns in Sweden by seeking representation on the nomination committee. Once this representation is obtained, the activist enjoys significant power in board appointments.

[103] C. Van der Elst, "Law and Economics of Shareholder Rights and Ownership Structures: How Trivial are Shareholder Rights for Shareholders?", Tilburg Law and Economics Center (TILEC) Law and Economics Discussion Paper No. 2010-009, February 2010, available at http://ssrn.com/abstract=1553094.

[104] Aminadav and Papaioannou, supra note 91.

[105] M. Holmén and P. Högfeldt, "Pyramidal Discounts: Tunneling or Overinvestment?", 9 *International Review of Finance* 133, 2009.

truckmaker Volvo, controlled by the *Industrivarden* sphere by way of dual-class shares (6.7% ownership, but 22% of votes) was targeted by Cevian, which succeeded in getting agreements as to board composition and stock performance, and eventually sold its 7.9% stake (carrying, however, only 25% of voting rights) to the Chinese Gelly (the owner of Volvo Cars).[106] Similarly, Cevian had a long engagement with Ericsson, controlled by *Investor* (the Wallenbergs' sphere). Cevian managed to replace the board's chairman despite being only the third-largest shareholder in terms of voting power (but the largest owner, with a 5.9% stake). In response, *Investor* raised its ownership to 6.6% of capital, with its voting power remaining at about 22%.[107] In this way, *Investor* reduced the difference between voting power and ownership (the so-called wedge)[108] enabled by the CEM. This story suggests that controlling shareholders are no longer immune from outside shareholders' pressure, but instead, like the managers of a typical U.S. company, they compete with activists for institutional investors' support. Increasing ownership, more than voting power, is a way for controlling shareholders to look more credible to the institutional investors that will call the shots in the event there is an activist campaign.[109]

Our argument that giving managers in manager-controlled companies leeway may be efficient in some cases applies with at least equal force to companies with controlling shareholders, whose interests are more aligned with their companies' interests. There is therefore no better reason – and perhaps a slightly worse reason – than in the case of management-controlled companies why a coalition of activist shareholders and institutional investors (such as index funds) should prevail over controlling shareholders in setting the company's strategy. So long as controlling

---

[106] See R. David and B. Katz, "Rolls-Royce, Volvo Replace CEOs as Activist Investors Gain Clout", *Bloomberg Business*, April 29, 2015, http://www.bloomberg.com/professional/blog/rolls-royce-volvo-replace-ceos-as-activist-investors-gain-clout/; T. Turula, "This Guy Made Nearly Two Billion Krona on Volvo's Stock Today – Thanks to 'The World Record in Analyst Mistakes'", *Business Insider Nordic*, April 25, 2017, https://nordic.businessinsider.com/this-guy-earned-nearly-two-billion-krona-on-volvos-stock-today---and-hes-thanking-a-world-record-analyst-mistake-for-the-windfall-2017-4/; R. Milne, "China's Geely Takes €3.25bn Stake in Truckmaker Volvo Group", *Financial Times*, Dec. 27, 2017, available at https://www.ft.com/content/98035c38-eadd-11e7-bd17-521324c81e23.

[107] See J. Thompson, "Ericsson Chairman Leif Johansson to Step Down under Pressure from Activist", *Financial Times*, July 5, 2017, available at https://www.ft.com/content/cc2c1a82-6157-11e7-91a7-502f7ee26895; "Investment firm Investor AB overtakes Cevian as top Ericsson owner", Reuters, Oct. 16, 2017, https://www.reuters.com/article/us-ericsson-equity/investment-firm-investor-ab-overtakes-cevian-as-top-ericsson-owner-idUSKBN1CL14L .

[108] See infra, text accompanying notes 210-212 (defining the "wedge").

[109] See infra, text accompanying notes 273-274.

shareholders' control is not absolute, they are situated similarly to corporate management, and the same arguments about leeway apply.

Why don't controlling shareholders simply acquire more shares and become majority shareholders (or even 100% owners) and hence significantly lessen (or even eliminate) the need to justify their decisions? Since the additional shares must be purchased, doing so is expensive.[110] In any event, a controller may not have enough wealth or may be unwilling to forgo the benefit of diversification to obtain control over a large corporate project. Moreover, and even for far smaller companies, a majority shareholder still would have justification needs given possible charter and statutory provisions empowering minority shareholders.

### *Why Arbitrage Doesn't Fix the Problem*

Our argument rests largely on theory and, admittedly, intuition. How can we know whether managers or other market actors are influenced by the need to justify their decisions? One analogy is to the debate as to whether executive compensation is market driven or the result of cronyism (or some other possibility). There are respectable arguments on differing sides, with evidence that can be marshaled, but nothing definitive exists.[111] Moreover, our argument as to the role of justification has much in common with the established alternatives – that managers will take advantage when they can, thus yielding traditional agency costs or that shareholder activists are also taking advantage or otherwise imposing costs, advancing their own interests to the detriment of others. In our account, the actors are also taking advantage, protecting their downsides in a way that may be contrary to what they are charged with doing. Finally, just as we cannot predict when and to what extent a manager or other actor would be more or less inclined to look to justification except to say that the costs of doing so should be more pernicious with increasing uncertainty, neither can traditional agency or other orthodox theorists explain to what extent advantage is taken (or not) or constrained.

Where are arbitrageurs in this story? Why aren't they 'correcting' the problematic decisions if there are costs being incurred that need not be incurred? Because we are

---

[110] However, as noted by I. M. Kirzner, *Perception, Opportunity and Profit: Studies in the Theory of Entrepreneurship* (University of Chicago Press, 1979), at 94, entrepreneurs do not need to be wealthy. In economics, ownership is never a condition for entrepreneurship; entrepreneurship is a special input rewarded by profit as opposed to return on capital.

[111] L. A. Bebchuk and J. M. Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004).

in the realm of uncertainty, assigning a value to future possibilities, even within a broad range, is very difficult.[112] Arbitrage's limits might be at issue in contexts like these, where there is no easily-computable 'fact of the matter'—that is, the payoff is uncertain and (far?) in the future. Arbitrageurs may be more attracted to 'informational inefficiency' than supposed 'fundamental inefficiency.' Recall Keynes's beauty contest analogy – markets are like beauty contests in which people are judging who the other judges will find beautiful.[113] The longer one has to wait for the payoff, the more, and more often, the trajectory has to be justified. This is true particularly when, as is usually the case, the arbitrageur is using borrowed money. There may be many people making the computations that are supposed to make the market efficient but, again, since, for quite a while, they only profit if they can convince others of their view, and since there may be a chain of people who need a canonical approach or quick results to continue funding, rather large potential value discrepancies might not get arbitraged away. An article in The Business Insider about Michael Burry, who became famous when he was described in Michael Lewis's *The Big Short*, helps make the point:

> Michael Burry saw the riskiness of the subprime market as millions of borrowers with low income and few assets bought homes and cars with tremendous leverage. … However, the banking system was valued as if these mortgages would all be paid. Burry realized that this could not possibly continue over the long-term.
>
> At the same time, Burry began to tell his investors of the enormous risks to the system. His investors were mostly institutions that did not want to hear his theory. Their other investments were all built upon the concept of a sound system with no subprime mortgage risk. Investors began to get nervous and demand their money back.
>
> Unfortunately, it was too late as Burry had already gotten into several long-term, illiquid bets against the market using derivatives to bet the price of

---

112 See Hill and McDonnell, "Short and Long Term Investors", supra note 22, for an explanation of why arbitrage might be unsuccessful in this context, albeit with less explicit reference to the concept of uncertainty. We would expect arbitrage to be more successful in contexts such as those involving traditional managerial agency costs – indeed, the beginnings of the leveraged buyout 'movement,' can, in significant part, be explained as a market correction of manager advantage-taking. Such advantage-taking was obviously value-decreasing (for those other than the managers) providing a money-making opportunity that was exploited.

113 See Keynes, *General Theory of Employment,* supra note 14, at 156. Interestingly, Keynes concluded the discussion of what is known today as 'limits to arbitrage' (see A. Shleifer & R. W. Vishny, "The Limits of Arbitrage", 52 *Journal of Finance* 35, 1997, https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1540-6261.1997.tb03807.x) with this language, which has been quoted many times since: "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally." Ibid., at 102.

> mortgages would fall. If he got out of the trades, he would suffer a huge loss – so Burry simply refused the investors' requests.
>
> All of a sudden in 2007 the market started to turn in his direction …Burry's investments paid off handsomely and he made $100 million for himself and $700 million for his investors.
>
> [But] the relationship had become so tainted that his investors refused to work with him again. Despite all of his success, Burry could not succeed in fundraising again for his fund and he liquidated the assets.[114]

***What follows?***

We have argued thus far that management should be accountable to financiers, but the efficient level of accountability varies with context. Accountability is needed to make external finance, particularly shareholding in publicly held companies, viable.[115] Accountability of corporate actors is particularly important today where a significant amount of retail savings is managed by institutional investors, which are, in turn, accountable to their clients.[116] Accountability, however, may lead management to choose the actions that can be justified as opposed to the actions reflecting their best judgment. The problem is when the two sets of actions differ. Managers' judgment may differ from what can be justified because managers are opportunist or incompetent, in which cases one would prefer accountability. However, managerial judgment may differ from what can be justified also when uncertainty is high. In this situation, accountability is less desirable for it may result in excessively defensive behavior.[117] A tradeoff exists between managerial discretion and accountability in corporate governance, the best solution to which depends on the degree of uncertainty a particular company is facing. [118]

When the uncertainty faced by the particular company at a particular point in time is high and competition is slow, it is efficient for shareholders to give management leeway to be entrepreneurial. To use Professor Gilson's metaphor, shareholders may

---

[114] John Szramiakje, "Here's the Story of One of the Heroes of 'The Big Short'", *BusinessInsider.com*, May 22, 2017, available at http://www.businessinsider.com/michael-burry-life-story-2017-5.

[115] A. Shleifer and R. W. Vishny, "A Survey of Corporate Governance", 52 *Journal of Finance* 737, 1997.

[116] See text accompanying note 53.

[117] See text accompanying notes 68-73.

[118] See A. M. Pacces, *Rethinking Corporate Governance: The Law and Economics of Control Powers* (Routledge, 2012), 145-146.

decide to keep management on a long leash.[119] Conversely, when the competitive environment is dynamic and uncertainty is low, it is efficient for management to be responsive to short-term feedback in terms of voice and/or stock price – in Gilson's words, shareholders should have management on a short leash. The key question is who should decide between long leash and short leash, when, and how. In what follows, we endeavor to answer this question based on theory, but also observation of corporate practices (and trends) around the world. In Section 4, we argue that companies should decide on the length of the leash through their charter, and be able to alter this choice later on by way of a charter amendment.

## Section 3: The corporate governance debate through the lens of existing laws and techniques

### *Setting the Stage*

In the previous Section, we discussed Third Point's 2013 activist engagement with Sotheby's. One particularly interesting aspect of the engagement is the following. To fend off Third Point and another hedge fund, Sotheby's adopted a poison pill with a differential trigger, a higher trigger for passive investors and a lower one for more active investors, Third Point sued to get the differential trigger removed, and lost in court. Yet by most measures Third Point "won" the battle. First, it got paid $10 million towards its expenses. Second, the head of Third Point, Dan Loeb, got a board seat, as did two other Third Point designees, and a bit later, the CEO of Sotheby's resigned.[120] Did Loeb have a better idea for how Sotheby's should be run? Time should tell.

Consider for contrast the following story. In the well-known 1989 case of *Paramount v. Time*,[121] the Delaware Supreme Court permitted the Time board to restructure a merger with Warner in order to avoid giving shareholders the ability to vote on a competing transaction, a hostile offer for Time by Paramount at a significant premium to Time's market price. "One concern was that Time shareholders might elect to tender into Paramount's cash offer in ignorance or a mistaken belief of the strategic benefit which a business combination with Warner might produce…Further, the timing of Paramount's offer to follow issuance of Time's proxy notice was viewed as

---

[119] R. J. Gilson, "From Corporate Law to Corporate Governance", in J. N. Gordon and W.-G. Ringe, eds., *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press, 2018) (noting the institutional complementarities for this outcome to be viable (including the example of Japan)).

[120] Hill, Quinn, and Davidoff Solomon, supra note 5, at 712-720.

[121] Paramount Communications, Inc. v. Time Inc., 571 A 2d.1140 (Del. 1989).

arguably designed to upset, if not confuse, the Time stockholders' vote."[122] The court held that "the fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals."[123] It seems fair to say that many, if not most, scholars who teach the case teach it an example of bad agents taking advantage and wanting to hold onto their jobs even if it meant depriving shareholders of the opportunity to accept a very high offer. The Paramount premium was quite large, and certainly in hindsight, the shareholders would have been far better off had they been able to accept it. But in this case, as is generally so, the agents said that they needed leeway to carry out their 'better idea.' And the court gave it to them.

In 2017, the Dutch printmaker Akzo Nobel N.V. was targeted by the U.S. hedge fund Elliott Management.[124] Akzo Nobel rejected a hostile takeover bid by the U.S. competitor PPG Industries on the grounds that "the proposal undervalue[d] AkzoNobel, contain[ed] significant risks and uncertainties, ma[de] no substantive commitments to stakeholders and demonstrate[d] a lack of cultural understanding."[125] Elliott challenged this decision in the Dutch specialist court for corporate affairs (the 'Enterprise Chamber'), which rejected the complaint. Shortly afterwards, Elliott filed a petition with the same Enterprise Chamber to have the chairman of Akzo's supervisory board removed. (Note that, in the Dutch dual-board model, the supervisory board appoints the management board). The Dutch court also rejected this petition. Interestingly, in both cases Elliot lost on grounds that shareholders cannot take control of the company's strategic direction away from the board. But, in practice, a (supervisory) board still needs the support of the company's shareholders to be re-elected. Note that Elliott had become the largest shareholder in Akzo, with a 9.5% stake, and claimed the support of Azko's top 20 shareholders.[126] And indeed, the Akzo board's victory was rather pyrrhic. The result of Elliott's engagement was a standstill agreement which gave Elliott one representative on the supervisory board, two agreed-upon independent supervisory board members, and a commitment to divest a part of Akzo's business. We will see what results: at this writing, Akzo is not doing particularly well.[127]

---

[122] Ibid. at 1153.

[123] Ibid. at 1154.

[124] B. H. Meijer and A. Deutsch, "Round Two: Elliott Advisors, Akzo Nobel Face Off in Dutch Court", Reuters, July 27, 2017, https://www.reuters.com/article/us-akzo-nobel-shareholders-activism-idUSKBN1AC11X.

[125] J. Sillars, "Dulux Firm AkzoNobel Rejects Third Takeover Bid from PPG", Sky News, May 8, 2017, https://news.sky.com/story/dulux-firm-akzonobel-rejects-third-takeover-bid-from-ppg-10868582.

[126] Meijer and Deutsch, supra note 124.

[127] T. Sterling, "U.S. Activist Investor Ends Feud with Dutch Paintmaker Akzo Nobel", Reuters, Aug. 16, 2017, https://www.reuters.com/article/us-akzo-nobel-shareholders-idUSKCN1AW0D3. See also J. Leijten and J.

In 2013, the Fiat group, which makes Fiat cars (and was formerly the largest listed Italian company) reincorporated the first of its holding companies – the group's truck maker CNH – into the Netherlands in order to introduce loyalty shares, something that was not allowed by Italian law until 2014.[128] The loyalty shares mechanism confers one extra voting right on all shareholders holding their stock for three years, as reflected in records kept by the company.[129] But the genius of this scheme, as we shall explain shortly,[130] is that shareholders must affirmatively agree to not transfer their shares except upon a requested de-registration, which then eliminates the extra voting rights. Shareholders apt to make such an agreement are far likelier to be the controlling shareholders, who do not contemplate selling their stock in the normal course, than many of the other shareholders, who are more likely to value liquidity, and in particular, institutional investors whose business models contemplate regular trading.[131] As a result, for example, the Agnelli family manages to control CNH with over 40% of voting rights but only 26% of the shares, indirectly owned by the family's fund Exor.[132] Contrast this with BlackRock, which owns 3.2% of the shares but only 2.5% of the voting rights. The Agnelli-controlled companies could not be targeted by an activist campaign even if an activist managed to garner the support of the majority of the shareholders.

---

Kooiman, "Akkoord AkzoNobel en Elliot over conflict", NRC.NL, Aug. 16, 2017, https://www.nrc.nl/nieuws/2017/08/16/akzonobel-en-elliot-begraven-strijdbijl-a1570067 (in Dutch).

Recent news (R. Bloemenkamp, "AkzoNobel Struggling against Headwinds", MarketMogul, May 8, 2018, https://themarketmogul.com/akzonobel/) reveal that Akzo has been struggling since the settlement of the battle with Elliott. After cashing in a super-dividend, Elliott has reduced its stake to about 5%. The company is expected to return more cash to shareholders in the near future. In 2018, Akzo's share price has fluctuated between €75-80 per share, which is lower than the highest offer received by PPG Industries (€96.75).

[128] The law in the Netherlands did not expressly allow loyalty shares, but its flexibility was such that the shares were effectively permitted. There were also subsequent reincorporations in 2014 (Fiat Chrysler Automobiles), 2015 (Ferrari) and 2016 (Exor).

[129] Shareholders who registered their shares at the moment of the (cross-border) merger into the Dutch entity received the loyalty shares immediately. See, e.g., CNH Industrial, "Loyalty Voting Structure", in *Annual Report 2014*, available at http://www.annualreport2014.cnhindustrial.com/en/report-operations/corporate-governance/loyalty-voting-structure. Shares must be deregistered in order to be traded. Deregistration implies losing the extra voting rifts. As of 31 December 2017, only the Agnelli family's fund, Exor, and Piero Ferrari (the son of Ferrari's founder) had registered their shares in the Fiat group companies to obtain loyalty shares.

[130] See infra, text accompanying note 236.

[131] For instance, index funds trade in order to replicate as much as possible the index that they are tracking. Dedicated funds profit from trading timely on their superior information. In both examples, gaining extra voting power is not sufficient motivation for institutional investors to limit their freedom to trade.

[132] CNH Industrial, *Annual Report 2017*, available at http://www.cnhindustrial.com/en-us/investor_relations/shareholder_meetings/shareholder_documents/2018/CNHI_Annual_report_2017.pdf. Note that, because the Agnelli family only owns around 53% of Exor, their economic interest in CNH is slightly above 14%.

***Hostile Takeovers and Shareholder Activism: The Role of Disclosure of Large Stakes***

The 1960s marked the emergence of so-called corporate raiders seeking to take over companies. While hostile takeovers have not gone away, the raiders' successors can be said to be shareholder activists, who try to influence companies to do what they think the companies should be doing (and are not doing.)[133]

The Williams Act, under the Securities Exchange Act of 1934, was passed in 1968.[134] When it was originally proposed in 1965, its focus was on the bad consequences of acquisitions. The Senator proposing the bill, Harrison Williams, stated that: "[i]n recent years we have seen proud old companies reduced to corporate shells after white-collar pirates have seized control with funds from sources which are unknown in many cases, then sold or traded away the best assets, later to split up most of the loot among themselves."[135] Williams acknowledged that the bill was intended to disadvantage corporate raiders.[136] The bill in its pro-management form was not adopted, however. The final bill represented an attempt to level the playing field, acknowledging the interests not just of management, but also of acquirers (and of course shareholders).

One of the most important provisions in the bill, Section 13(d), requires disclosure of stakes larger than 5% in companies subject to the '34 Act (that is, public companies), so that management is not taken by surprise, finding out that there is a large shareholder it had not previously known about. The disclosure, on Schedule 13D, is to be made within 10 days of the acquisition, during which time the acquirer can acquire an unlimited number of additional shares.[137]

There have been considerable disputes as to what Section 13(d) requires and what it should require. Should the ten-day period be shortened? Should there be a limit on

---

[133] See generally A. N. Vollmer and P. R. Q. Wolfson, "The Williams Act: A Truly 'Modern' Assessment", *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), Oct. 22, 2011, *available at* https://corpgov.law.harvard.edu/wp-content/uploads/2011/10/The-Williams-Act-A-Truly-Modern-Assessment.pdf. See also Hill, Quinn, and Davidoff Solomon, supra note 5, 9-12.

[134] Pub. L. 90–439, July 29, 1968, 82 Stat. 454. See Vollmer and Wolfson, supra note 133, at 5-7; Hill, Quinn, and Davidoff Solomon, supra note 5, at 93-95. One important focus of regulation in the Williams Act was acquirers seeking to acquire companies for cash. They were subject to very few requirements, especially in contrast to acquirers who sought to use stock to make their acquisitions.

[135] 111 *Congressional Record* 28257 (1965).

[136] See Vollmer and Wolfson, supra note 133.

[137] Section 13(d) of the Williams Act is codified at 15 U.S.C. § 78m.

acquisitions during the ten-day period? What counts as ownership, and when should different 'owners'' interests be aggregated for reporting purposes?[138] (There is something curious about the debate. The initial time periods were established when determining ownership, and making required filings, took considerable time, whereas now both can be done extremely quickly. Yet the debate is conducted at full volume, as though the technological change were somehow irrelevant.)

The ten-day window to disclose the acquisition of significant stakes is important for shareholder activists' business model. Such activists, typically activist hedge funds, profit mostly from identifying companies they believe are undervalued, bringing about changes, and securing a sufficient share of the gains from such changes to make their engagement worthwhile.[139] Typically, the activist purchases a small but significant stake in the company, a toehold, sometimes smaller than the disclosure threshold, and then begins its campaign seeking to persuade the management to implement particular changes.[140]

Having to disclose an acquisition of shares immediately would complicate activists' ability to conduct their campaigns. Not only would managers have more time to react, including by erecting defenses, but more importantly, stricter disclosure requirements would reduce the activist's returns. These returns depend significantly, albeit not necessarily exclusively, on the accumulation of a toehold while the market is still in the dark about the activist's intentions.[141] As a result of the disclosure, the stock price quickly comes to incorporate the expectations of activist's engagement and further gains, if any, would have to be shared with the other shareholders. As noted above, the disclosure requirement was enacted when the acquisitions at issue were those by corporate raiders who would seek control of the company, to give management time to react. Although the possibility of cheaply purchasing a toehold

[138] See Hill, "An Identity Theory of the Short- and Long-Term Investor Debate," supra note 24, at 483-88 and citations therein.

[139] Because activist shareholders profit from identifying target companies whose stock market returns can be improved at least in the short term, this has been called entrepreneurial activism. A. Klein & E. Zur, "Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors", 64 *Journal of Finance* 187, 2009.

[140] Initial stakes can vary widely, as can post-disclosure acquisitions. See generally Lazard's Shareholder Advisory Group, *2017 Activism Year in Review*, January 2018, available at https://www.lazard.com/media/450414/lazards-review-of-shareholder-activism-q4-2017pdf.pdf

[141] See text accompanying notes 77-78.

affects the profitability of takeovers as well, takeover bidders have several other ways to recoup the cost of screening the market for potential targets.[142]

The present-day debate over how attenuated a person's relationship with shares of stock can be before she is considered an owner of that stock, whether the window to report should be ten days, and what someone can do during the window, is between those who think shareholders are needed to constrain managers, and those who think managers need more leeway to pursue the company's interests. Those who support Section 13(d) in its present form are in the former camp; those who think Section 13(d) should be tightened to require more disclosure or restrict acquisitions during the 10 day period are in the latter camp.

The debate may be shifting, but in somewhat contradictory ways. First, at this juncture, might the specter of activist engagement may be sufficiently pervasive that the 13(d) filing would be experienced by a company as a difference in degree rather than a difference in kind? That is, on this view, activism is an ever-present threat, and companies (that is, managers) shouldn't wait until a 13(d) is filed to act (that is, defend themselves). 13(d) would not be doing enough for managers on this view – and even tightening it up so that more disclosure was required would not save managers from having to fend off activists. Second, and going in the opposite direction: could the stylized dance-off, where activist interest is something to be discouraged and guarded against, be at times giving way to something more nuanced, wherein companies take seriously the idea that activists might be a source of good ideas? Whether companies see activist engagement as unfortunate but inevitable, or potentially a good thing, today's trend is towards regular company engagement with all sorts of investors.[143]

As discussed in Section 2, underlying the debates as to what Section 13(d) should require (and as to staggered boards and poison pills) are the two canonical worldviews, one in which traditional agency costs of managers loom large, such that vigilance to ensure they do not 'take advantage' is warranted, and the other in which some subset of shareholders are trying to 'take the money and run,' for their own

---

[142] See S. Betton, B. E. Eckbo, and K. S. Thornburn, "Corporate Takeovers", in B. E. Eckbo, ed., *Handbook of Corporate Finance: Empirical Corporate Finance*, Vol. 1 (North-Holland, 2008). On the contrary, Gilson and Gordon, supra note 53, at 904, argue that "toehold acquisitions are the major source of the activist's return".

[143] Activist Insight 2018, supra note 78; see also J. P. Morgan Chase & Co., *The 2017 Proxy Season: Globalization and a New Normal for Shareholder Activism*, available at https://www.jpmorgan.com/jpmpdf/1320739681811.pdf; F. Partnoy and S. Davidoff Solomon, "What CEOs Get Wrong About Activist Investors", *Harvard Business Review*, May 1, 2018, available at https://hbr.org/2018/05/what-ceos-get-wrong-about-activist-investors.

benefit but to the ultimate detriment of the corporation and its shareholders.[144] But the need to address justification costs is not part of that story. Section 13(d) serves as some constraint on management relative to, for instance, a regime with disclosure at a far higher threshold (or, for that matter, no disclosure). But the constraints, such as they are, are applicable to all companies – Section 13(d), and its functional equivalents in Europe[145] apply to every listed company and do not allow opting out. Generically, Section 13(d) may lead to more engagement between managers and activists than might be the case were its requirements less expansive. But nothing about the engagements thus far seems to appropriately address the justification issue. Our solution, described in detail in Section 4, provides for a particular sort of leeway agreed to under particular circumstances; we expect that agreement is particularly apt to be reached under conditions of uncertainty, where justification-motivated decisions would impose more costs than the agency costs minimized by more and more traditional managerial constraint. We express no view as to the broader 13(d) debate; our perspective is simply that a regulatory regime applicable to all companies does not address the issue of justification costs insofar as these call for company-specific solutions.

***Antitakeover Statutes***

Just as law sought to give managers fair warning of accumulations of stock of their companies, it also sought, at management's behest, to put obstacles in the way of acquirers who management disfavored.[146] Beginning in the 1960s, U.S. states began adopting antitakeover statutes after they were approached by companies in their states fearing actual or potential hostile acquirers. Early statutes took a variety of different forms, and some were invalidated. Eventually, in two decisions, the U.S. Supreme Court provided sufficient guidance as to the types of provisions that would

[144] One of us discusses the competing worldviews, anchoring them to competing prototypes and identities, in Hill, "An Identity Theory of the Short- and Long-Term Investor Debate," supra note 24.

[145] European rules on ownership disclosure are stricter than in the US. EU law (Directive 2004/109/EC as amended by Directive 2013/50/EU) mandates disclosure of stakes exceeding 5% within four days of crossing the threshold, but several European jurisdictions (e.g., the UK, Italy, and the Netherlands) set lower thresholds (e.g. 3%) and shorter time windows (e.g. immediately). Moreover, the recent revision of the EU Shareholder Rights Directive (Directive 2017/828/EU amending Directive 2007/36/EC) will impose identification of any shareholder larger than 0.5%, which might further curb shareholder activism in (continental) Europe. See Pacces, "Shareholder Activism in the CMU", supra note 24.

[146] Commentators have persuasively argued that the current debate on the short-termism stemming from hedge fund activism resembles that of the 1980s on the short-termism stemming from hostile takeovers. History does not seem to have borne out the claim that hostile takeovers destroyed value through short-termism. See S. N. Kaplan, "Are U.S. Companies Too Short-Term Oriented? Some Thoughts", in J. Lerner and S. Stern, eds., *Innovation Policy and the Economy*, Vol. 18 (NBER/University of Chicago Press, 2018). More likely, the argument as to whether short-termism (however defined) creates or destroys value is more nuanced, and context-specific. See Gilson, "From Corporate Law to Corporate Governance", supra note 119.

and would not pass muster.[147] Antitakeover statutes now take many different forms, including: business combination statutes, which prevent bidders conducting a tender offer from merging with a target without getting board approval or an extremely high percentage of the shares in the offer; fair price statutes, which require all shares to be acquired at the same price; and control share acquisition statutes, granting other shareholders a right to prevent a shareholder acquiring a significant percentage of the company's shares from voting those shares.[148] There are also statutes dealing with staggered boards; we deal with those below. 43 U.S. states have antitakeover statutes of some sort.[149]

Recent empirical work has found that these statutes probably do not have much effect.[150] (Other mechanisms, notably the poison pill, especially in combination with staggered boards, are far more effective, at least to fend off hostile takeovers. [151] As we will discuss in the next two subsections, the pill by itself or even with a staggered board is of only limited effectiveness against activists.)

Significantly, for our purposes, the adoption of these laws has been justified by, and used to perpetuate, the traditional story, of managers seeking to hold onto their jobs without regard to whether doing so is good for the shareholders, to the exclusion of other accounts of managerial behavior.

In part of this story, managers sometimes claim to be solicitous of other constituencies, such as employees, when they are 'really' being solicitous to themselves.[152] They are, for instance, turning down a potential acquirer's bid, not because they fear that their employees will be fired, but because they fear that they themselves will be fired. Indeed, so-called other constituency statutes, statutes that expressly allow managers to take interests other than those of shareholders into

---

[147] G. Subramanian, S. Herscovici, and B. Barbetta, "Is Delaware's Antitakeover Statute Unconstitutional? Evidence from 1988-2008", 65 *Business Lawyer* 685, 2010. See also E. M. Catan and M. Kahan, "The Law and Finance of Antitakover Statutes", 68 *Stanford Law Review* 629, 2016; M. D. Cain, S. B. McKeon, and S. Davidoff Solomon, "Do Takeover Laws Matter? Evidence from Five Decades of Hostile Takeovers", 124 *Journal of Financial Economics* 464, 2017, https://doi.org/10.1016/j.jfineco.2017.04.003.

[148] See Hill, Quinn, and Davidoff Solomon, supra note 5, at 458-9

[149] See Cain, McKeon, and Davidoff Solomon, supra note 147.

[150] Ibid.; Catan and Kahan, supra note 147.

[151] L. Bebchuk, J. Coates IV, and G. Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy", 54 *Stanford Law Review* 887, 2002.

[152] See Hill, Quinn, and Davidoff Solomon, supra note 5, at 456-7 and sources cited therein.

account in their decision- making, are sometimes characterized as antitakeover statutes.[153]

The list of managers running to their state legislatures to request some form of protection against acquirers is long: Aetna's managers, in Connecticut; Burlington, in North Carolina; Arvin, in Indiana; Goodyear, in Ohio; Boeing, in Washington; Dayton Hudson, in Minnesota; Gillette, in Massachusetts; Heileman Brewing, in Wisconsin.[154] Pennsylvania's law is, according to some commentators, particularly helpful for managers seeking to entrench themselves. It requires significant payments to workers who would lose their jobs in a merger, which this characterization assumes that management favors more to discourage acquirers, who would not want to make those payments, than to compensate any laid-off workers. Still, organized labor joined with the Chamber of Commerce to persuade the legislature to adopt Pennsylvania's law.[155]

At least in theory, the Williams Act "levels the playing field" whereas antitakeover laws are admittedly pro-management.[156] And the canonical story here is, it seems fair to say, anti-management – management is building a fortress around itself, closing itself to change that might be good. Antitakeover laws have far less direct effect on those who would simply seek to influence management rather than to take it over, but less effect does not mean no effect, especially insofar as activists are increasingly getting involved in various respects in takeovers.[157] For our purposes, though, the critical point is that if these laws do anything, they sometimes grant leeway to management. As such, they might seem to be useful to reduce justification costs. The problem is, however, that they do not necessarily grant leeway to management when our theory suggests it would be needed. Accountability- less leeway- should reduce bonding and monitoring costs. And, where there is less uncertainty, what is justifiable may also be the best decision all things considered, such that justification costs should be lower in such cases. Thus, without appreciable uncertainty, more leeway might

[153] See, e.g., B. H. McDonnell, "Shareholder Bylaws, Shareholder Nominations, and Poison Pills", 3 *Berkeley Business Law Journal* 205, 2005, at 250 (conceptually linking "constituency statutes and other antitakeover statutes"); R. B. Tyler, "Other Constituency Statutes", 59 *Missouri Law Review* 373, 1994, at 377-380.

[154] See Hill, Quinn, and Davidoff Solomon, supra note 5, 456-7. See also R. Romano, "The Future of Hostile Takeovers: Legislation and Public Opinion", 57 *University of Cincinnati Law Review* 457, 1988, available at http://digitalcommons.law.yale.edu/fss_papers/1948/; R. Romano, "Rethinking Takeover Regulation", 5 *Journal of Applied Corporate Finance* 47, 1992, DOI: 10.1111/j.1745-6622.1992.tb00225.x.

[155] B. S. Black, "Shareholder Passivity Reexamined", 89 *Michigan Law Review* 520, 1990.

[156] According to Jonathan Macey, the Williams Act is also pro-management. See J. R. Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press, 2008).

[157] Activist Insight 2018, supra note 78, at 6 ("One of [the new] forms of activism was influencing the structure and outcome of M&A.").

raise bonding and monitoring costs without doing much if anything to reduce justification costs.

With those and other laws in the background, various techniques have arisen to give management an ability to ward off unwanted suitors. We describe those techniques below. They have enjoyed varying degrees of effectiveness; for a period, it seemed fair to characterize management's ability to keep control as quite high, whereas now, activists' powers are formidable.

### ***Staggered Boards***

The first technique we discuss is staggered boards. Staggered boards are boards whose directors are not elected annually. Instead, there are different classes of board members, and each class's term is multi-year, ending in a different year.[158] A typical staggered board would have three classes, each with a term of three years, so that in each year, only one-third of the board is elected, and obtaining majority control requires two election cycles, which should serve to deter many acquirers. Under Delaware law, Delaware being where most publicly traded companies in the U.S. are incorporated, directors on such a board can only be removed for cause unless the certificate provides otherwise (Delaware General Corporation Law (DGCL) §141(k)(1)); under the MBCA, directors can be removed without cause unless the certificate provides otherwise. (MBCA §8.08(a)). But as a practical matter the result is the same: directors of companies with staggered boards generally cannot be removed without cause, either because of the statute (DGCL) or a certificate provision (MBCA); in the latter case, where the statutory default is otherwise, those choosing a staggered board will also choose the certificate provision since removal without cause frustrates the purpose of the staggered board.

Staggered boards thus make a company harder to take over. Is this a good or a bad thing? Again, that depends on whether one thinks that managers may take advantage of their insulation to act in their self-interest, including by not subjecting themselves sufficiently to market forces that might suggest that a change was appropriate (for instance because they are hyperopic, being willing to wait 'too long' for their

---

[158] Companies' certificates of incorporation (charters) or by-laws can provide for a staggered board, although most staggered boards are provided for in the corporation's charter. Indeed, while Delaware General Corporation Law (DGCL §141(d)) permits staggered boards to be provided for in the certificate or the bylaws, the Model Business Corporation Act (MBCA) requires staggered boards to be provided for in the charter. (MBCA §8.06). Changes to corporate charters must be approved by the board and the shareholders, while changes to bylaws can be made by shareholders. Under Delaware law, if the initial certificate or by-laws do not provide for a staggered board, a company must obtain shareholder approval to adopt a certificate or by-law amendment allowing it to have such a board. (DGCL §141(d)).

strategies to pay off),[159] or whether they need the longer term to counteract effects of myopia and carry out projects with longer time horizons. It also depends on whether the deterrence effect on suitors for such companies is larger than the higher price the more ardent suitors that remain will pay.

Staggered boards apparently date from the 1920s, but only became popular in the 1980s, during the first takeover wave.[160] Many companies have had such boards, although at present, many fewer do (and very few do on the S&P 500), owing to considerable pressure on companies to de-stagger their boards.[161] The pressure has come from governance activists, including, notably, Lucian Bebchuk's Shareholder Rights Project at Harvard Law School, which was largely focused on getting companies to get rid of their staggered boards. [162] Many did so, and the project was terminated.

The Shareholder Rights Project was highly controversial for various reasons, some of which are not relevant for our purposes (such as the role of Harvard, and whether the project counted as 'practicing law.') But what is relevant for us is the debate between those who believe staggered boards are bad for companies and those who disagree.

---

[159] "[T]here is a risk that both institutional investors and activist investors may be myopic, to the end of increasing the value of a speculative option. But there is a corresponding risk that company managers may be hyperopic, acting to increase the option value of their control by extending its length, especially if, because of poor performance and strategy, it is then out of the money." Gilson and Gordon, supra note 53, at 917.

[160] Bebchuk, Coates, and Subramanian, supra note 151, 994. Regarding the debate over staggered boards and their impacts, see generally K. J. M. Cremers and S. M. Sepe, "The Shareholder Value of Empowered Boards", 68 *Stanford Law Review* 67, 2015; Y. Amihud, M. Schmid, and S. Davidoff Solomon, "Do Staggered Boards Affect Firm Value?", forthcoming, *Iowa Law Review*, available at http://cear.gsu.edu/files/2017/04/Steven-Somonon_Staggered-boards.pdf; E. Catan and M. Klausner, "Board Declassification and Firm Value: Have Shareholders and Boards Really Destroyed Billions in Firm Value?", NYU Law and Economics Research Paper No. 17-39, Sept. 1, 2017, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2994559; R. Weill, "Declassifying the Classified", 31 *Delaware Journal of Corporate Law* 891, 2006; M. Ganor, "Why Do Managers Dismantle Staggered Boards?", 33 *Delaware Journal of Corporate Law* 149, 2008; M. G. Doré, "The Iowa Business Corporation Act's Staggered Board Requirement for Public Corporations: A Hostile Takeover of Iowa Corporate Law?", 60 *Drake Law Review Discourse* 1, 2012; D. Kim, Board Classification and Shareholder Value: Evidence from Corporate Law Amendments, Doctoral Dissertation, Business Administration, University of Texas at Austin, 2016, available at https://repositories.lib.utexas.edu/bitstream/handle/2152/38159/KIM-DISSERTATION-2016.pdf?sequence=1.

[161] EY Center for Board Matters, "IPO Corporate Governance Then and Now: The Evolution of Board and Governance Practices Three Years After the IPO", *Board Matters Quarterly*, January 2017, at 7-8, available at http://www.ey.com/Publication/vwLUAssets/EY-board-matters-quarterly-january-2017/$FILE/EY-board-matters-quarterly-january-2017.pdf; C. Bowie, "ISS 2016 Board Practices Study", *Harvard Law School Forum on Corporate Governance and Financial Regulation (blog), June 1, 2016, available at* https://corpgov.law.harvard.edu/2016/06/01/iss-2016-board-practices-study/; "Fewer Classified Boards Could Mean Higher Director Turnover", *Equilar Blog*, March 7, 2016, available at http://www.equilar.com/blogs/84-fewer-classified-boards.html.

[162] "Shareholder Rights Project—121 Companies Agreed to Move towards Annual Elections", 2017, available at http://www.srp.law.harvard.edu/companies-entering-into-agreements.shtml.

Underlying and motivating the project, it would seem, is the 'staggered board as entrenching management' view, in which manager agency costs are front and center, and managers very much need the possibility of discipline from at least the prospect of directors they didn't choose, or associated ease by which the company might be taken over. As we have discussed, opponents of the project paint shareholder activists as preventing directors, and management more broadly, from being able to carry out ideas that are good for the company.

Interestingly, several states have enacted laws requiring staggered boards, at least as a default. Some of the laws were enacted to help local corporations seeking to fend off hostile acquirers. The Iowa law was adopted at the behest of Casey's, a company seeking to avoid being taken over by Alimentation Couche-Tard, Inc., a Canadian corporation. A hostile bid for Norton Company prompted the Massachusetts bill; regular calls by Ball shareholders for Ball to de-stagger its board prompted the Indiana statute, and Oklahoma's staggered board statute was designed to assist Chesapeake Energy retain its staggered board.[163] Oklahoma repealed its law two years after adopting it, once activist shareholders nevertheless managed to replace the majority of the Chesapeake board, and threatened to re-incorporate in Delaware.[164] The laws' genesis might seem to support at least their motivation, if not their effect, to entrench boards and management. But do they? And if so, is that problematic if their effect is positive for companies?

---

[163] Iowa Code § 490.806(A) (Supplement 2011); Massachusetts General Laws Annotated, chapter 156B, § 50A, chapter 156D, § 8.06(b)–(g) (West 2005 & Supplement 2011) (codifying Massachusetts' staggered board law); Indiana Code Annotated, § 23-1-33-6(c) (LexisNexis 2010); Oklahoma Statutes Annotated, title 18, § 1027(D) (West 1999 & Supplement 2012); Doré, supra note 160, at 4-8; M. M. Brown et al., § 103[B], "Charter and Bylaws", in *Takeovers: A Strategic Guide to Mergers and Acquisitions*, 2017 Supplement, at 1-9 n.14.

[164] J. Wertz, "Declassified: Chesapeake Wants 'Relief' from an Oklahoma Law It Helped Write", *NPR—State Impact*, June 8, 2012, available at https://stateimpact.npr.org/oklahoma/2012/06/08/declassified-chesapeake-wants-relief-from-an-oklahoma-law-it-helped-write/; "Oklahoma Reverses Law, Chesapeake Energy Pleased", *Akron Beacon Journal—Ohio.com* (blog), March 20, 2013, available at https://www.ohio.com/akron/pages/oklahoma-reverses-law-chesapeake-energy-pleased; D. Gilbert, "Chesapeake Gets Reversal of Oklahoma Staggered-Terms Law", *Wall Street Journal*, March 19, 2013, available at https://www.wsj.com/articles/SB10001424127887323639604578370730747650130. Interestingly, in 2013, shareholders rejected the company's attempt to return to a unified board; fewer than the required votes to eliminate the staggered board structure were cast in favor of doing so. See "Chesapeake Energy Shareholders Reject Board Declassification", Reuters, June 14, 2003, https://www.reuters.com/article/us-chesapeakeenergy-meeting/chesapeake-energy-shareholders-reject-board-declassification-idUSBRE95D0OY20130614. But in 2014, shareholders did approve the company's proposal to declassify the board, and since then, the board has been a unitary, unclassified board. See J. F. Marks, "Chesapeake Shareholders Approve Reforms", *NewsOK*, June 14, 2014, https://newsok.com/article/4912918/chesapeake-shareholders-approve-reforms.

The debate on this subject has been active and heated.[165] Empirical evidence has been offered to show that they are bad for company value,[166] good for company value,[167]

[165] Much of the heat in the debate has come from sparks flying between shareholder rights champion Lucian Bebchuk and leading shareholder activism critic and poison pill inventor Marty Lipton. See, e.g., L. Bebchuk, "Wachtell Lipton Was Wrong About the Shareholder Rights Project", *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), April 9, 2013, available at https://corpgov.law.harvard.edu/2013/04/09/wachtell-lipton-was-wrong-about-the-shareholder-rights-project/; L. Bebchuk, "Still Running Away from the Evidence: A Reply to Wachtell Lipton's Review of Empirical Work", *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), March 5, 2014, available at https://corpgov.law.harvard.edu/2014/03/05/still-running-away-from-the-evidence-a-reply-to-wachtell-liptons-review-of-empirical-work/; L. Bebchuk, "Don't Run Away from the Evidence: A Reply to Wachtell Lipton", *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), September 17, 2013, available at https://corpgov.law.harvard.edu/2013/09/17/dont-run-away-from-the-evidence-a-reply-to-wachtell-lipton/; M. Lipton and T. Mirvis, "Harvard's Shareholder Rights Project is Wrong", *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), March 12, 2012, available at https://corpgov.law.harvard.edu/2012/03/23/harvards-shareholder-rights-project-is-wrong/; M. Lipton, "The Bebchuk Syllogism", *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), August 26, 2013, available at https://corpgov.law.harvard.edu/2013/08/26/the-bebchuk-syllogism/; M. Lipton, "Current Thoughts About Activism", *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), August 9, 2013, available at https://corpgov.law.harvard.edu/2013/08/09/current-thoughts-about-activism/. See also, e.g., Cremers and Sepe, "The Shareholder Value of Empowered Boards", supra note 160; K. J. M. Cremers and S. Sepe, "Board Declassification Activism: The Financial Value of the Shareholder Rights Project", working paper, June 2017, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2962162; L. Bebchuk and A. Cohen, "Recent Board Declassifications: A Response to Cremers and Sepe", *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), May 23, 2017, available at https://corpgov.law.harvard.edu/2017/05/23/recent-board-declassifications-a-response-to-cremers-and-sepe/; K. J. M. Cremers and S. Sepe, "Board Declassification Activism: Why Run Away from the Evidence?", working paper, June 2017, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2991854; K. J. M. Cremers, L. P. Litov, and S. Sepe, "Staggered Boards and Long-Term Firm Value, Revisited", 126 *Journal of Financial Economics* 422, 2017, https://doi.org/10.1016/j.jfineco.2017.08.003; A. Cohen and C. C. Y. Wang, "How Do Staggered Boards Affect Shareholder Value? Evidence from a Natural Experiment", 110 *Journal of Financial Economics* 627, 2013, https://doi.org/10.1016/j.jfineco.2013.08.005; Y. Amihud and S. Stoyanov, "Do Staggered Boards Harm Shareholders?", working paper, November 2015, available at http://www.wlrk.com/docs/DoStaggeredBoardsHarmShareholders.pdf; A. Cohen and C. C. Y. Wang, "Staggered Boards and Shareholder Value: A Reply to Amihud and Stoyanov", working paper, December 2015, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2697352; Y. Amihud and S. Stoyanov, "Do Staggered Boards Harm Shareholders?", 123 *Journal of Financial Economics* 432, 2017, https://doi.org/10.1016/j.jfineco.2016.04.002; A. Cohen and C. C. Y. Wang, "Reexamining Staggered Boards and Shareholder Value", *125 Journal of Financial Economics* 637, 2017, https://doi.org/10.1016/j.jfineco.2017.06.004; Kim dissertation, supra note 160.

[166] See, e.g., Bebchuk, Coates, and Subramanian, supra note 151; L. A. Bebchuk and A. Cohen, "The Costs of Entrenched Boards", 78 *Journal of Financial Economics* 409, 2005; Cohen and Wang, "How Do Staggered Boards Affect Shareholder Value?", supra note 165; Cohen and Wang, "Reexamining Staggered Boards and Shareholder Value", supra note 165; O. Faleye, "Classified Boards, Firm Value, and Managerial Entrenchment", 83 *Journal of Financial Economics* 501, 2007; R.-J. Guo, T. A. Kruse, and T. Nohel, "Undoing the Powerful Anti-Takeover Force of Staggered Boards", 14 *Journal of Corporate Finance* 274, 2008; O. Karakaş and M. Mohseni, "Staggered Boards and the Value of Voting Rights", working paper, updated May 2017, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2628954.

[167] See, e.g., Cremers and Sepe, "The Shareholder Value of Empowered Boards", supra note 160; Cremers, Litov, and Sepe, supra note 165; A. K. Buchholtz et al., "The Shareholder Democracy Paradox: An Empirical Examination", *Academy of Management Proceedings*, 1, 2009, available at

have no effect on company value,[168] or have certain good effects for certain types of firms.[169] Different people have different views as to what should be done, depending on their views as to staggered boards. As noted above, Professor Bebchuk has worked to get companies to eliminate their staggered boards. Professors Cremers and Sepe, whose empirical work supports the value of staggered boards under some circumstances, have argued for a change in law wherein staggered boards should be the default configuration: "the board should have exclusive authority to initiate a charter amendment to opt out of the staggered board default," and "Rule 14a-8 of the Securities Exchange Act, which allows shareholders to submit precatory proposals, should be amended to exclude destaggering proposals from the range of admissible proposals." "In its strongest version, this proposal would also involve rolling back majority voting standards by mandating the adoption of plurality voting standards." "Moreover, in order to ensure widespread shareholder agreement, the board's destaggering proposal should be subject to a two-thirds supermajority requirement."[170]

It is perhaps not surprising that empirical evidence supports such different conclusions. Obviously, over the period of time that must be taken into account, many things are happening. There will never be two corporations, identical but for the fact that one has a staggered board and the other does not. Indeed, companies with

---

http://proceedings.aom.org/content/2009/1/1.74.full.pdf+html; D. F. Larcker, G. Ormazabal, and D. J. Taylor, "The Market Reaction to Corporate Governance Regulation", 101 *Journal of Financial Economics* 431, 2011, doi:10.1016/j.jfineco.2011.03.002; W. Ge, L. Tanlu, and J. L. Zhang, "What Are the Consequences of Board Destaggering?", 21 *Review of Accounting Studies* 808, 2016, doi 10.1007/s11142-016-9362-2.

[168] See, e.g., Amihud, M. Schmid, and S. Davidoff Solomon, "Do Staggered Boards Affect Firm Value?", supra note 160; Amihud and Stoyanov, supra note 165; S. Ahn and K. Shrestha, "The Differential Effects of Classified Boards on Firm Value", 37 *Journal of Banking and Finance* 3993, 2013, http://dx.doi.org/10.1016/j.jbankfin.2013.07.029. See also P. Gompers, J. L. Ishii, and A. Metrick, "Corporate Governance and Equity Prices", 118 *Quarterly Journal of Economics* 107, 2003 (finding good and bad effects of different approaches to corporate governance canceling each other out over time).

[169] See, e.g., M. J. Rose, "Heterogeneous Impacts of Staggered Boards by Ownership Concentration", 15 *Journal of Corporate Finance* 113, 2009, doi:10.1016/j.jcorpfin.2008.09.008; A. Duru, D. Wang, and Y. Zhao, "Staggered boards, Corporate Opacity and Firm Value", 37 *Journal of Banking & Finance* 341, 2013, http://dx.doi.org/10.1016/j.jbankfin.2012.09.002; W. C. Johnson, J. M. Karpoff, and S. Yi, "The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms", 117 *Journal of Financial Economics* 307, 2015, https://doi.org/10.1016/j.jfineco.2015.03.008 (discussing advantages of takeover defenses for IPOs with major existing customers and business relationships).

[170] Cremers and Sepe, "The Shareholder Value of Empowered Boards", supra note 160. We compare this proposal with ours in Section 4.

staggered boards are different from those without staggered boards precisely because of the staggered boards.[171]

A recent empirical paper addressed the staggered board debate, noting first the two main opposing positions: "One theory claims that a staggered board facilitates entrenchment of inefficient management and thus harms corporate value. Consequently, some institutional investors and shareholder rights advocates have argued for the elimination of the staggered board. The opposite theory is that staggered boards are value enhancing since they enable the board to focus on long-term goals. Both theories are supported by prior and conflicting studies and theoretical law review articles." The paper concluded, however, that "neither theory has empirical support," and that "on average, a staggered board has no significant effect on firm value." "The effect of a staggered board is idiosyncratic; for some firms it increases value, while for other firms it is value destroying." The authors conclude that their "results suggest caution about legal solutions which advocate wholesale adoption or repeal of the staggered board and instead point to an individualized firm approach.[172] A forthcoming paper argues to the contrary, that staggered boards are value-adding in certain circumstances.[173] And so it continues.

Where does this leave us? Until recently, the debate was largely conducted using the language of traditional agency costs, wherein the default or reigning presumption seems to have been that managers were using such boards to entrench themselves. With the emphasis on technical empirical work, the theoretical underpinnings are less in evidence. As noted above, there are major disputes as to what empirical evidence shows. Interestingly for our purposes, one empirically grounded dispute is as to whether particular companies do better with staggered boards. Some authors argue that staggered boards are valuable for companies that are engaged in innovation;[174] other authors argue that the evidence shows no such thing.[175] The former being correct is at least consistent with, and may provide some support for, our theory.

---

[171] See, e.g., Amihud, Schmid, and Davidoff Solomon, "Do Staggered Boards Affect Firm Value?", supra note 160. See also discussion in note 24, supra.

[172] Y. Amihud, M. Schmid, and S. Davidoff Solomon, "Settling the Staggered Board Debate", (September 8, 2017), forthcoming, *University of Pennsylvania Law Review*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3034492.

[173] K. J. M. Cremers and S. M. Sepe, "Is the Staggered Board Debate *Really* Settled**?"** (2018), working paper on file with the authors.

[174] See, e.g., Cremers, Litov, and Sepe, supra note 165.

[175] See, e.g., Amihud, Schmid, and Davidoff Solomon, "Do Staggered Boards Affect Firm Value?", supra note 160.

Our bottom line is that even if staggered boards are helpful for companies engaged in innovation, we think our solution, described in Section 4, is more precisely focused on the problem at issue. Staggered boards do get at managerial leeway for a particular period of time, just as our solution does. But staggered boards are not particularly effective in fending off activists, as we explain below. Moreover, staggered boards are not suitable as a way to give managers leeway for a specified (three, five, any) number of years, and/or under a prescribed set of conditions, as we recommend in this article. A company either has a staggered board or it does not: managers' and shareholders' only options are to introduce or remove a staggered board, and for strategic reasons, they may fail to do so.

***Poison Pills***

To complement our consideration of staggered boards, we briefly discuss poison pills. Poison pills were invented by Martin Lipton of Wachtell, Lipton, Rosen & Katz, in 1982, the 'heyday of corporate raiders.' An article described Lipton's motivation in inventing the pill as "giving boards of a target company a chance to 'level the playing field' and have time to weigh offers."[176] Pills effectively require an acquirer to negotiate with a board or replace the board – they make the acquirer's shares lose value once the acquirer exceeds a certain share threshold. The acquirer can't just buy shares from shareholders in a tender offer; at a certain point, the pill is triggered and shareholders other than the acquirer can buy additional shares at a price that effectively dilutes the value of the of acquirer's stock. Acquirers hence won't 'buy through the pill.' A board can adopt a pill without shareholder approval. It can also remove a pill at any time before it is triggered- that is, before the acquirer buys the threshold amount.

Especially in combination with a staggered board, a poison pill is a particularly effective deterrent to hostile pursuit of a company. Pills by themselves are not very effective at deterring hostile acquirers because the acquirers can mount a proxy fight to replace the board. Pills combined with staggered boards, though, result in needing two election cycles to replace the majority of the board needed to eliminate the pill, making the two together an extremely potent combination, at least against hostile takeover attempts.[177]

By contrast, poison pills have limited effectiveness in fending off shareholder activists. Poison pills impose severe financial penalties on those buying more shares

[176] S. Ovide, "Marty Lipton: Why I Invented the Poison Pill", *Wall Street Journal*, December 29, 2010, available at https://blogs.wsj.com/deals/2010/12/29/marty-lipton-why-i-invented-the-poison-pill/.

[177] See Hill, Quinn, and Davidoff Solomon, supra note 5, at 443-447; Bebchuk, Coates, and Subramanian, supra note 151.

than a triggering threshold, but they do not restrict those buying less than such a threshold. Activists can still profit from the acquisition of a toehold below the pill threshold. Moreover, poison pills are not effective against a 'wolf pack' of activist hedge funds[178] so long as the wolf pack is able to avoid meeting definitions under which their holdings would be aggregated so as to meet the threshold. And again, in the absence of a staggered board, a proxy fight can yield new board members who would redeem the pill to allow the activist to acquire more than the low threshold.

Even in the presence of a staggered board, proxy fights also can yield board members who are more receptive to the activist's ideas as to how to run the company.[179] How can a proxy fight be won? Activists (and for that matter acquirers) must garner sufficient support from other shareholders to win a proxy fight. Note that shareholders are more likely to vote against a management that has ignored shareholder proposals receiving majority support,[180] including proposals to de-stagger the board.[181] Because the presence of a staggered board increases the probability of management losing a proxy fight, even the combination of poison pills with staggered boards is ultimately ineffective against shareholder activists.

Empirical work on poison pills has tended to find them to be value-reducing.[182] That being said, since just about every company can quickly adopt a poison pill, in a sense all companies have a pill, even if only a "shadow" pill. Companies with pills thus can't be compared with those without them to determine whether the pill has an impact on the company's value.[183] Finally, recent work considering whether pills are value-

---

[178] This is because U.S. law is quite lenient on treating a group of shareholders as acting in concert. See Coffee and Palia, supra note 30, at 564, 568-569. European rules are stricter (and thus less welcoming for wolf packs). See Kraakman et al., *The Anatomy of Corporate Law*, supra note 90, at 60-61. However, as we will explain in the text accompanying notes 186-190, infra, European jurisdictions do not feature poison pills.

[179] This can sometimes backfire. In Airgas, the hostile acquirer got its nominees elected to the board but those nominees, as board members, actually voted against the acquirer's proposed acquisition. Air Products and Chemicals, Inc. v. Airgas, Inc., 16 A.3d 48 (Delaware Chancery Court, 2011).

[180] S. Choi, J. Fisch, and M. Kahan, "Who Calls the Shots?: How Mutual Funds Vote on Director Elections", 3 *Harvard Business Law Review* 35, 2013, at 61.

[181] See Coffee and Palia, supra note 30, at 603 ("[I]t is probably already too late to save the staggered board, as momentum has gathered to purge it in all cases.")

[182] See, e.g., R. Comment and G. W. Schwert, "Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures", 39 *Journal of Financial Economics* 3, 1995, available at https://www.sciencedirect.com/science/article/pii/0304405X9400823J; K. J. M. Cremers and A. Ferrell, "Thirty Years of Shareholder Rights and Firm Value", 69 *Journal of Finance* 1167, 2014, available at https://onlinelibrary.wiley.com/doi/abs/10.1111/jofi.12138.

[183] See, e.g., J. C. Coates IV, "Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence", 79 *Texas Law Review* 271, 2000; M. Klausner, "Empirical Studies of Corporate Law and Governance: Some Steps Forward and Some Steps Not", Stanford University and European Corporate Governance Institute Law Working Paper No. 381/2018, January 2018, available at http://ssrn.com/abstract=3097568.

reducing has argued that it is not that pills are value-reducing; rather, the value reduction comes first, and the pill comes afterwards.[184]

Note how the traditional debate is instantiated in both the impetus for the pills' development, and the sometimes-negative reaction to the pill. Consider this discussion from a 2012 article from Time Magazine, Corporate Raiders Beware, discussing poison pills in the context of Carl Icahn's pursuit of Netflix:

> Proponents of poison pills say that they protect companies from slash-and-burn corporate raiders more interested in making a quick buck than in nurturing a long-term strategy that will enable companies to reach their full potential.
>
> If nothing else, they force hostile takeover artists to negotiate with boards, and put pressure on potential buyers to increase their bids. One 2005 study by FactSet found that companies using poison pills were able to raise their price tag 24% higher than companies without such plans. In the case of Peoplesoft, the takeover target only agreed to rescind its poison pill provisions and allow itself to be bought by Oracle after the larger company more than doubled its bid from an initial $5.1 billion to $10.3 billion.
>
> Critics of poison pills, like Icahn, describe these supposed "shareholder-rights plans" as inimical to real shareholder rights. Poison pill provisions, he complains in a post on his blog (yes, Carl Icahn has a blog), "can be put in place and removed by the directors as they please whenever they please without a shareholder vote." Pointing out that other countries put many more restrictions on companies instituting poison pill plans, he argues that the boards of American companies "should not be allowed to hide behind a poison pill indefinitely." Shareholder "activists" like Icahn claim that they help to shake out bad management and unlock value in troubled companies. Shareholders frustrated with management often welcome the attention of shaker-uppers like Icahn.[185]

[184] See E. M. Catan, "The Insignificance of Clear-Day Poison Pills", NYU Law and Economics Research Paper No. 16-33, September 7, 2016, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2836223; Cremers et al., "Shadow Pills and Long-Term Firm Value", working paper, January 18, 2018, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3074658; Cremers and Ferrell, supra note 182; Coates, supra note 183.

[185] David Futrelle, "Corporate Raiders Beware: A Short History of the 'Poison Pill' Takeover Defense", *Time*, Nov. 7, 2012, available at http://business.time.com/2012/11/07/corporate-raiders-beware-a-short-history-of-the-poison-pill-takeover-defense/.

Again, here is the traditional framing: the 'good agent' managers need protection against the "slash and burn" raiders "more interested in making a quick buck than in nurturing a long-term strategy that will enable companies to reach their full potential," or the 'bad agent' boards are "hiding" indefinitely behind poison pills, needing to be "shaken up" by the prospect and perhaps fact of losing their jobs.

To us, the lessons here are fourfold. First, the empirical work here is largely driven by the traditional framing. Second, as is the case with empirical work in related areas, the work does not and cannot elucidate how justification concerns might be affecting the results—this is not being tested for. Third and most importantly, the evidence is consistent with the possibility that giving managers more leeway is at least not value-detracting, and may be value-adding. Fourth, the poison pill is just one of the many ways to grant management leeway, and perhaps not even the most effective way in the face of activist shareholders (as opposed to hostile bidders).

After our consideration of 13(d), antitakeover laws, poison pills, and staggered boards, we consider alternative strategies, which have been more frequently used by non-U.S. companies.

### *The (Lesser) Role of Staggered Boards and Poison Pills in Europe*

Outside the U.S., staggered boards and poison pills do not play nearly as important a role in corporate governance. In Europe, for instance, staggered boards do not make much difference in terms of management accountability to shareholders, for several reasons. First, many European jurisdictions provide shareholders with the non-waivable right to remove directors at will, which, combined with the right of shareholders to call special meetings to replace directors,[186] makes staggered boards ineffective to entrench the board.[187] Second, in Europe, staggered boards cannot be combined with poison pills. In most European jurisdictions, the issuance of new

---

[186] This right is typical of European jurisdictions. See Kraakman et al., *The Anatomy of Corporate Law*, supra note 90, at 55-56. By contrast, in Delaware, the default rule is that shareholders cannot call such a meeting. Ibid. See DGCL Section 211(d). Some Delaware corporations provide for shareholder-called special meetings if certain conditions are met, but this is not the norm. Other states' laws vary. Governance activists have proposed, sometimes with success, that companies' charters or bylaws be amended to allow shareholders to call special meetings. See generally https://corpgov.law.harvard.edu/2016/09/02/special-meeting-proposals-2/.

[187] See Kraakman et al., *The Anatomy of Corporate Law*, supra note 90, 55-56.

shares requires shareholder approval,[188] which deprives poison pills of their fundamental appeal, the fact that they can be adopted unilaterally by the board. [189]

Finally, as discussed in Section 2, at least in continental Europe, a majority of listed companies have controlling shareholders who, by definition, control the board.[190] Staggered boards play at most a minor role in this setting. The presence of a controlling shareholder makes the discussion of takeover defenses, such as staggered boards and poison pills, largely irrelevant because a change in control normally requires the controlling shareholder's approval. In the presence of a controlling shareholder, the key variable is voting power, in particular whether the latter is sufficient for controlling shareholders to prevail over dissident shareholders at the general meeting. This power is normally sufficient to fend off a hostile acquirer,[191] but not necessarily enough to avoid pressure from shareholder activists. [192]

Because staggered boards also exist where there are controlling shareholders, they must serve some function other than management entrenchment. Staggered boards seem to support the stability of governance in the aftermath of an IPO (for instance, to reflect the founder's vision) or even directors' independence from certain

---

[188] Ibid., 216-217.

[189] Some European jurisdictions, such as the Netherlands and France, support functionally equivalent takeover defenses. These, however, work differently than the pill. Functional equivalents to the U.S. poison pills are, for instance, the French "bons Breton" or the Dutch protective preference shares. Similar to the poison pill, these mechanisms work through the issuance of new shares. Crucially, in France as well as in the Netherlands, the board must be preauthorized by a shareholder meeting to issue these shares, and the authorization requires periodic renewal (for instance, every 5 years in the Netherlands). Due to other legal constrains, these mechanism do not dilute the hostile bidder as does the poison pill. In France, the bons Bretons are warrants that must be issued to all the existing shareholders, though the shares acquired through the (mandatory) bid do not count, which effectively dilutes a successful bidder. In the Netherlands, there is no economic dilution, but simply a very cheap issuance of shares accounting for 50% of the voting rights by a formally independent, but as a practical matter board-friendly, foundation ("Stichting"). See ibid., 216-217; and L. Chazen and P. Werdmuller, "The Dutch Poison Pill: How is it Different from an American Rights Plan?", *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), December 1, 2015, available at https://corpgov.law.harvard.edu/2015/12/01/the-dutch-poison-pill-how-is-it-different-from-an-american-rights-plan/.

[190] Kraakman et al., *The Anatomy of Corporate Law*, supra note 90, 79-89.

[191] Even if the controlling shareholder does not own more than 50% of the company, she will normally have enough voting power to approve the board's defensive tactics and in any event, to block a post-takeover squeeze-out, which, in Europe requires a majority of 90% or even 95%. See Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids, 2004 OJ (L142) 12, available at https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:142:0012:0023:EN:PDF.

[192] As we have seen in Section 2, this depends on whether controlling shareholders are majority shareholders and on the statutory rights of minority shareholders in many European jurisdictions (for instance, the appointment of a short slate of directors). In other words, activists may interfere with the controlling shareholders' choices, although they cannot oust them from control.

constituencies,[193] notably including other controlling shareholders. Notwithstanding controlling shareholders' control of the board, and their sometime-ability to fire all of its members without cause, staggering the terms of office mildly commits controllers to preserving board autonomy. That controlling shareholders sometimes choose staggered boards supports our point that staggered boards may be efficient in certain contexts.

### *Deviations from One Share One Vote: Dual Class Shares and Loyalty Shares*

One other approach that potentially addresses the issues raised by shareholder activism is deviating from "one-share, one-vote" (1S1V). As we noted in Section 2, departures from 1S1V are implemented via what are called Control Enhancement Mechanisms (CEMs), giving managers or controlling shareholders voting power disproportional to their ownership. CEMs are responses to hostile takeovers and shareholder activism; they are *functionally* equivalent to staggered boards and poison pills. However, insofar as the pressure on management to make justification-motivated decisions stems more from the threat of activism than from the threat of a hostile takeover, 1S1V departures are becoming more important than traditional takeover defenses. One reason is that, as we have seen, the most powerful U.S. takeover defense – the poison pill/staggered board combination – is not always effective against shareholder activists. Furthermore, outside the U.S., takeover defenses are not common, in part because so many companies have controlling shareholders, and controlling shareholders have less need of such defenses to fend off hostile takeovers.[194] However, controlling shareholders may be like managers in their aversion to shareholder activists. Thus, they, like managers, may want to enhance their voting power in order to lessen the probability or power of activist engagement.

[193] R. B. Adams, "Chapter 6—Boards, and the Directors Who Sit on Them", in B. Hermalin and M. Weisbach, eds., *The Handbook of the Economics of Corporate Governance*, Vol. 1 (North-Holland, 2017).

[194] Note the important exception of the Netherlands, in which takeover defenses have traditionally played a prominent role in corporate governance. See A. de Jong, A. Röell, and G. Westerhuis, "Changing National Business Systems: Corporate Governance and Financing in the Netherlands, 1945–2005", 84 *Business History Review* 773, 2010. Perhaps the most powerful of these defenses, the so-called protective preference shares, is effective also against shareholder activists. See Chazen and Werdmuller, supra note 189. However, as evidenced by the AKZO Nobel case discussed at the beginning of this Section, even "unsuccessful" activists may ultimately get their way.

Departure from 1S1V can be achieved in a number of ways. Examples of CEMs include pyramidal group structures, cross ownerships, dual class shares,[195] and more recently, loyalty shares (also known as tenure voting).[196] In this article, we will focus on the two most popular techniques.[197] These are dual class shares, where, paradigmatically, one class, held by founders and/or her family members has the only, or a much higher, vote, than the other class, and loyalty shares, which gain greater voting power when they are held for longer periods.

### ***Dual-Class Shares***

Dual class stock is a mechanism by which, traditionally, one set of owners retains control over a company. The second 'class' can be nonvoting, or have some limited voting power while the first class stays in control. The paradigmatic use is by a founder retaining control of her company notwithstanding conducting a public offering, but dual class shares need not be issued only at the IPO stage. Insofar as dual class stock entrenches management, it does so because the shareholders who continue to control the company on account of their shares of the controlling class of shares favor, or, not infrequently, are, the management.

Dual class stock has long been controversial because it violates the 1S1V principle. From 1926 and lasting for nearly 60 years, companies with dual-class stock could not be listed on the New York Stock Exchange.[198] Facing pressure by competing exchanges, NYSE relaxed the prohibition in 1984. This allowed companies to introduce dual class stock in midstream, prompting the SEC to prohibit dual-class

---

[195] L. A. Bebchuk, R. Kraakman, and G. Triantis, "Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control From Cash-Flow Rights", in R. K. Morck, ed., *Concentrated Corporate Ownership* (University of Chicago Press, 2000).

[196] L. L. Dallas and J. M. Barry, "Long-Term Shareholders and Time-Phased Voting", 40 *Delaware Journal of Corporate Law* 541, 2015.

[197] Pyramidal groups and cross-ownership are problematic insofar as they may be used not only to enhance voting power, but also to expropriate value from investors. The most developed jurisdictions try to avoid expropriation by regulating conflicts of interest strictly, for instance in related-party transactions. See, e.g., A. M. Pacces, "Procedural and Substantive Review of Related Party Transactions (RPTs): The Case for Non-Controlling Shareholder-Dependent (NCS-Dependent) Directors", ECGI Law Working Paper No. 399/2018, May 2018, available at https://ssrn.com/abstract=3167519. Such regulations, however, increase the cost of these techniques to separate voting power from ownership.

[198] R. J. Jackson, Jr., "Perpetual Dual-Class Stock: The Case Against Corporate Royalty", speech transcript, undated, available at https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty.

recapitalization.[199] The SEC prohibition was eventually struck down by courts, but it was reintroduced by the stock exchanges. As a result, in the U.S., listed companies cannot introduce shares that have more than one vote per share in midstream.[200] They may, however, go public with multiple classes of stock. Moreover, they may issue nonvoting stock in midstream.

The arguments favoring and opposing dual class stock are the familiar ones: will management use the leeway of not having to fear takeovers to pursue innovative long-term projects, or to entrench itself? And, not surprisingly, there is a debate, as a matter of both theory and empirical evidence, as to the effect of dual-class shares on company value, with support for the proposition that they add value,[201] that they have no effect,[202] and that they are value-reducing. [203] Very well-known companies such as Google and Facebook have gone public with dual-class capital structures, arousing considerable debate.[204] Dual class shares companies have become so

---

[199] S. M. Bainbridge, "The Short Life and Resurrection of SEC Rule 19c-4", 69 *Washington University Law Quarterly* 565, 1991.

[200] See generally L. A. Bebchuk & K. Kastiel, "The Untenable Case for Perpetual Dual-Class Stock", 103 *Virginia Law Review* 585, 2017, at 596-9.

[201] B. S. Sharfman, "A Private Ordering Defense of a Company's Right to Use Dual Class Share Structures in IPOs", forthcoming, *Villanova Law Review*, 2018, available at http://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=2591&context=fac_pubs. See also T. J. Chemmanur and Y. Jiao, "Dual class IPOs: A Theoretical Analysis", 36 *Journal of Banking and Finance* 305, 2012, available at https://www2.bc.edu/thomas-chemmanur/paper/Dual%20Class%20IPOs.pdf.

[202] G. Morey, *Multi-Class Stock and Firm Value: Does Multi-Class Stock Enhance Firm Performance? A Regression Analysis*, Council of Institutional Investors, May 2017, available at https://www.cii.org/files/publications/misc/05_10_17_dual-class_value_study.pdf.

[203] B. Nicholas and B. Marsh, "Dual-Class: The Consequences of Depriving Institutional Investors of Corporate Voting Rights", *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), May 17, 2017, available at https://corpgov.law.harvard.edu/2017/05/17/dual-class-the-consequences-of-depriving-institutional-investors-of-corporate-voting-rights/ (this is admittedly from a law firm that represents institutional investors, some of which are presumably 'deprived' in this sense); IRRC Institute, *Controlled Companies in the Standard & Poor's 1500: A Ten Year Performance and Risk Review*, October 2012, available at https://irrcinstitute.org/wp-content/uploads/2015/09/FINAL-Controlled-Company-ISS-Report1.pdf; P. Gompers, J. L. Ishii, and A. Metrick, "Extreme Governance: An Analysis of Dual-Class Firms in the United States", 23 *Review of Financial Studies* 1051, 2010, https://doi.org/10.1093/rfs/hhp024.

[204] See, e.g., A. Tan and B. Robertson, "Dual-Class Shares Are Coming Under Fire—Again: Class Warfare Erupts as Markets and Investors Wrestle with Shareholders' Preferential Voting Rights," *Bloomberg Markets*, September 28, 2017, available at https://www.bloomberg.com/news/articles/2017-09-27/can-democracy-stage-a-comeback-at-stock-exchanges; Joann S. Lublin, "Big Investor Group to Push for End to Dual-Class Shares: Coalition's Corporate-Governance Campaign Turns Up the Heat on Many U.S. Companies", *Wall Street Journal*, January 31, 2017, available at https://www.wsj.com/articles/big-investor-group-to-push-for-end-to-dual-class-shares-1485817380; Eva Marcotrigiano, "Facebook Shareholder Pushes for 1 Share, 1 Vote", *Westlaw Corporate Governance Daily Briefing*, June 13, 2016, 2016 WL 3223678; Matt Orsagh, "Dual-Class Shares: From Google to Alibaba, Is It a Troubling Trend for Investors?", *Market Integrity Insights* (blog), April 1, 2014, available at https://blogs.cfainstitute.org/marketintegrity/2014/04/01/dual-class-shares-from-google-to-alibaba-is-it-a-troubling-trend-for-investors/.

prominent in the US markets that they account for nearly 10% of the value of the main indices.[205]

Dual class stock has increasingly been criticized. Following lobbying from the Council of Institutional Investors (CII), an organization that primarily represents U.S. pension funds, S&P Dow Jones decided to exclude all new dual class offerings from its main indices (including the prominent S&P 500). Similarly, the FTSE Russell now excludes from its indices all companies which have less than 5% of their voting rights held by public investors.[206] Moreover, since 2017, ISS has recommended voting against directors of companies with dual-class shares structures that do not have "reasonable" sunset mechanisms.[207] ISS's recommendation reflects investors' increasingly negative view of 'perpetual' dual-class stock. [208] Indeed, investors are increasingly requesting that companies include sunset provisions when implementing dual-class stock structures.[209]

Dual class shares have always been a way for companies to entrench their management. If the managers, or the controlling shareholders supporting them, command more than half of the votes, the company is effectively insulated from hostile takeovers and from shareholder activists as well. Because, at least in the U.S.,[210] there are no statutory restrictions on how far voting power may depart from ownership, dual class shares may grant managers control regardless of their ownership. For instance, if supervoting shares command ten votes per share, owning one share more than 5% of the company is sufficient to control it. The difference between voting rights and ownership is 45%. This difference is called the "wedge." The wedge is a measure of the control enhancement provided by this mechanism, as well as by other CEMs.

---

[205] Bebchuk and Kastiel, "The Untenable Case", supra note 200, at 594; M. Cremers, B. Lauterbach, and A. Pajuste, "The Life-Cycle of Dual Class Firms", ECGI Finance Working Paper No. 550/2018, May 2018, at 5, available at https://ssrn.com/abstract=3062895 or http://dx.doi.org/10.2139/ssrn.3062895.

[206] B. S. Sharfman, "The S&P and FTSE Russell Should Reverse Course on Dual Class Shares", *Oxford Business Law Blog*, Nov. 8, 2017, https://www.law.ox.ac.uk/business-law-blog/blog/2017/11/sp-and-ftse-russell-should-reverse-course-dual-class-shares.

[207] A. W. Winden, "Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures", forthcoming, *Columbia Business Law Review*, earlier version as Stanford University Rock Center for Corporate Governance Working Paper Series No. 228, August 2017, at 4, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3001574.

[208] See Jackson, "Perpetual Dual-Class Stock", supra note 198.

[209] Professor Bebchuk and Kastiel have argued for doing precisely this. See Bebchuk and Kastiel, "The Untenable Case", supra note 200. See also text accompanying notes 278-287.

[210] Such limits exist in other jurisdictions. For instance, 1:10 is the maximum in Sweden. See Pacces, *Rethinking Corporate Governance*, supra note 118, 207.

CEMs are not recent inventions. Indeed, they have a long history (including in academic debates).[211] Because the traditional takeover defenses have only limited effectiveness against activist shareholders, dual class shares have recently become a subject of considerable interest. In the U.S., such shares may be the only effective defense against activists, and are regarded by activists as a major hurdle.[212] In a similar vein, institutional investors have traditionally opposed deviations from 1S1V. That being said, their opposition hasn't prevented them from buying into dual-class stock companies, and BlackRock, a leading provider of index funds, has publicly criticized S&P and FTSE's decisions to exclude dual class companies from their indices.

Outside the U.S., there are different regimes governing dual class stock. In the UK, the investor community was more effective than they were in the U.S. at opposing dual class shares. Traditionally, UK listed companies avoided such shares. With the influx of foreign companies into the UK market, however, the number of companies with dual class shares increased.[213] Institutional investors lobbied, successfully, for a regulatory reaction. As a result, the Financial Conduct Authority introduced a rule mandating 1S1V for all the companies admitted to the Premium Listing of the London Stock Exchange.[214] This approach is consistent with the UK tradition of banning takeover defenses.[215]

Continental Europe has been somewhat less welcoming to hostile takeovers. Reflecting this posture, dual class shares are more common in continental Europe than they are in the U.S and the UK.[216] Some jurisdictions (e.g. the Netherlands) have always allowed dual-class shares along with several other takeover defenses; in other jurisdictions (e.g. Sweden) dual class shares have always been common; other

---

[211] See, e.g., Gompers, Ishii, and Metrick, "Extreme Governance", supra note 203; Bebchuk, Kraakman, and Triantis, supra note 195.

[212] M. Weingarten and E. Klein, "2016 Shareholder Activism Report", *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), Dec. 1, 2016, available at https://corpgov.law.harvard.edu/2016/12/01/2016-shareholder-activism-insight-report/.

[213] B. R. Cheffins, "The Undermining of UK Corporate Governance (?)", 33 *Oxford Journal of Legal Studies* 503, 2013.

[214] See P. Davies, "Related Party Transactions: UK Model", ECGI Law Working Paper No. 387/2018, February 2018, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3126996 at 45 (commenting on the UK Listing Rule 7.2.1A).

[215] D. Kershaw, "The Illusion of Importance: Reconsidering the UK'S Takeover Defence Prohibition", 56 *International & Comparative Law Quarterly* 267, 2007.

[216] On average, they account for about one fourth of listed companies, according to M. Bennedsen and K. M. Nielsen, "Incentive and Entrenchment Effects in European Ownership", 34 *Journal of Banking & Finance* 2212, 2010, available at http://www.kaspermeisnernielsen.com/IEEO_JBF.pdf.

jurisdictions (e.g. Italy) have long allowed nonvoting shares and recently introduced multiple voting shares. This higher frequency of dual-class shares is unsurprising given that in many European jurisdictions, by contrast with the United States, boards cannot fend off a hostile takeover unless shareholders authorize them to do so.[217] In these countries, companies may only be insulated from hostile takeovers or shareholder activists if they have a controlling shareholder. Many of these controlling shareholders employ CEMs to secure their position even though they own less, and sometimes significantly less, than half of the company's equity.

Deviations from 1S1V are problematic from the perspective of incentive alignment. Controllers whose financial stake is smaller than their voting power have less incentive to create value for the shareholders as a group.[218] This is of course a familiar story -- the controllers with their disproportionately high voting power play the role of managers, less vigilant about pursuing shareholder value than their own advantage. 1S1V is classic incentive alignment: voting power is in proportion to share ownership and hence economic interest.[219] A few commentators, including one of us,[220] have criticized the one-size-fits-all character of this preference for 1S1V. Separation of control and ownership, including as a result of CEMs, the existence of a controlling shareholder, and the use of takeover defenses, happens too often for it to be inefficient. For example, in 2015, 15% of U.S. IPOs had dual-class stock.[221] Indeed neither theory nor empirical evidence can demonstrate that as a general matter 1S1V

[217] See article 9 of the European Parliament and Council Directive 2004/25/EC, supra note 191, and L. Enriques, R. J. Gilson, and A. M. Pacces, "The Case for an Unbiased Takeover Law (with an application to the European Union)", 4 *Harvard Business Law Review* 85, 2014, available at http://www.hblr.org/wp-content/uploads/2014/08/HLB103_crop.pdf, on how it is implemented in Europe. More generally, see Pacces, *Rethinking Corporate Governance*, supra note 118, at 212-221, on legal distribution of powers. See also, e.g., M. J. Van Ginneken, "The US Poison Pill from a Dutch Perspective", in S. H. M. A. Dumoulin, ed., *Tussen Themis en Mercurius* (Kluwer, 2005), 121-141, at 122 (noting how the 13th EU Directive on takeover bids from 2004 states that "once a takeover bid is announced, the target board may not take frustrating action without approval of the general meeting of shareholders, to be given after the announcement of the bid."). Yet certain EU jurisdictions, such as the Netherlands, have nevertheless developed ways to defend against hostile takeovers without a shareholder vote. Regarding the Dutch use of the "stichting" system, sometimes referred to as the "Dutch Poison Pill," see, e.g., Chazen and Werdmuller, supra note 189; S. Raice and M. Patrick, "The Rise of the 'Stichting,' an Obscure Takeover Defense: Mylan Puts in Place an Ancient But Powerful Dutch Legal Structure to Fend Off Teva's Hostile Bid," *Wall Street Journal*, April 22, 2015, available at https://www.wsj.com/articles/the-rise-of-the-stichting-an-obscure-takeover-defense-1429716204.

[218] See Gompers, Ishii, and Metrick, "Extreme Governance", supra note 203.

[219] S. J. Grossman and O. D. Hart, "One Share-One Vote and the Market for Corporate Control", 20 *Journal of Financial Economics* 175, 1988.

[220] Pacces, *Rethinking Corporate Governance*, supra note 118, at 218-221.

[221] Cremers, Lauterbach, and Pajuste, supra note 205, at 1.

is efficient – or inefficient.[222] Most likely, whether a dual class structure is efficient depends on context. As argued by Professors McCahery and Vermeulen, this context evolves with time, over the firm's life cycle. As a consequence, initially efficient arrangements as to the ownership and control structure may later become inefficient. Importantly, this inefficiency does not depend on accountability being excessive or insufficient per se, but rather on the failure of ownership and control structures to support the goals of "sustainable" (long lasting) growth and value creation. [223]

To understand how dual class shares work, it is useful to look at why a shareholder would acquire a controlling interest and how the existence of such an interest affects the company. Private benefits of control (PBC) reward the extra effort and cost of owning a substantial portion of the company in order to control it. PBC are usually regarded as a source of inefficiency in corporate governance, but this is not necessarily the case. First, there are at least two kinds of PBC. One kind reduces shareholder value, for instance by expropriation. This kind of PBC includes the traditional agency costs, such as those arising from self-dealing and empire building. The other kind, for instance the appropriation of psychic benefits that are worthless to investors, does not.[224] Both kinds of PBC may reward corporate control. Even when they reduce shareholder value, the alternative – managerial control – may be worse, insofar as managers also can extract PBC. They may be more apt to do so than controlling shareholders are since controlling shareholders' financial stake in the corporation makes the extraction of value-reducing PBC less attractive.[225]

Second, controlling shareholders may have a vision, i.e. they may be entrepreneurs in the sense discussed in this article. Although commentators have argued that the controller's ability to realize her vision should not be understood as a private benefit

---

[222] See J.-N. Caprasse, C. Clerc, and M. Becht, *Report on the Proportionality Principle in the European Union* 15, 26–27, May 2007, available at http://ec.europa.eu/internal_market/company/docs/shareholders/study/final_report_en.pdf; M. Burkart and S. Lee, "One Share—One Vote: The Theory", 12 *Review of Finance* 1, 2008, https://doi.org/10.1093/rof/rfm035; R. Adams and D. Ferreira, "One Share—One Vote: The Empirical Evidence", 12 *Review of Finance* 51, 2008, https://doi.org/10.1093/rof/rfn003.

[223] J. A. McCahery and E. P. M. Vermeulen, "The 'Ignored' Third Dimension of Corporate Governance", 2 *Journal of Self-Governance and Management Economics* 69, 2014, also available in an earlier version as ECGI Law Working Paper No. 235/2014, January 2014, available at https://ecgi.global/working-paper/ignored-third-dimension-corporate-governance. Our proposal expands on this intuition, as we discuss infra, text accompanying notes 288-299.

[224] R. J. Gilson, "Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy", 119 *Harvard Law Review* 1641, 2006.

[225] See R. Gilson and A. Schwartz, "Contracting About Private Benefits of Control", ECGI - Law Working Paper No. 216/2013, 2013, available at http://www.ecgi.global/sites/default/files/working_papers/documents/SSRN-id2182781.pdf.

of control,[226] again, this is not necessarily the case. As argued by one of us,[227] the reward of this vision, namely of entrepreneurship, can be characterized as PBC if investors do not value it but controllers do. Such benefits reflect, for instance, the pride of controlling a company that has realized the controller's vision. Because these PBC are idiosyncratic to the controlling shareholder, they are called idiosyncratic PBC.

Idiosyncratic PBC have important implications for dual class shares and control enhancing mechanisms. Going public with a dual class shares structure implies a discount on the shares sold to the investing public, as the latter anticipate adverse consequences from incentive misalignment—that is, they pay less for x% of the shares that hold x% of the equity but less than x% of the votes, since they presume that those holding disproportionately high percentages of the vote will act in their own interest as much or more as they do in the interests of those holding disproportionately low percentages of the vote. The owners of the shares prior to the IPO bear this discount as the opportunity cost of opting out of a 1S1V structure. It follows that owners choosing a dual class stock structure must accord as high a value to the idiosyncratic PBC as they do to the increase in the discount on noncontrolling stock reflecting the investors' heightened concerns about value-decreasing PBC (i.e. agency cost). The discount on noncontrolling stock causes the controlling shareholder to limit the control enhancement to an amount justified by the size of her idiosyncratic PBC.[228] Only a large size of the latter will allow for a large discount, and hence a large departure from 1S1V, i.e. a large wedge. Large wedges are not often observed. In fact, founders have to retain some degree of ownership in equilibrium to signal their commitment, thereby keeping the IPO discount down to acceptable levels (the higher the wedge, the higher the discount).[229] Moreover, distinct from the

[226] Z. Goshen and A. Hamdani, "Corporate Control and Idiosyncratic Vision", 125 *Yale Law Journal* 560, 2016, available at http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=5734&context=ylj.

[227] Pacces, *Rethinking Corporate Governance*, supra note 118, at 16, 94-95 (drawing on the definitions given in A. M. Pacces, *Featuring Control Power: Corporate Law and Economics Revisited* (Rotterdam Institute of Law and Economics, 2008)).

[228] See A. M. Pacces, "Control Matters: Law and Economics of Private Benefits of Control", ECGI Law Working Paper No. 131/2009, 2009, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1448164. To be sure, the controller may decide to extract value-decreasing PBC, for instance by way of perks or empire building, instead of idiosyncratic PBC. However, this strategy would be inefficient ex-ante. As shown by Grossman and Hart, supra note 219, when the only issue is agency cost, it is privately optimal to go public with a 1S1V voting structure that commits to low PBC extraction via competition in the market for corporate control.

[229] This is in line with the recent finding that the degree of ownership matters for the success of dual class IPOs. See D. Cumming, M. Meoli, and S. Vismara, "Investors' Choice between Cash and Voting Rights: Evidence from Dual-Class Equity Crowdfunding", 2018, working paper on file with the authors (showing, in the context of equity crowdfunding, that higher wedges are associated with a lower probability of success, a lower likelihood of attracting professional investors, and poorer long-term performance). The same reasoning applies to our

controller's vision as such, idiosyncratic PBC can be cashed in as a control premium if, later on, the controlling shareholder decides to part with control.[230] This is also an important effect. Because the prospect of selling control at a premium is realistic so long as a buyer can emerge, the controlling shareholder is induced to be realistic in estimating idiosyncratic PBC ex ante, which also contributes to limiting the size of the wedge between ownership and control.

This approach to dual class-shares structures provides a plausible explanation for how they can be efficient when they are established. A controller facing uncertainty ex ante may, at the IPO stage, choose a governance system in which she will not have to justify her decisions to investors, so long as she is willing to pay a price for this (in the form of a discount on the noncontrolling stock) and investors accept this price (buying noncontrolling stock at a discount).

But this account, in which dual class shares can be efficient, is not complete. Dual class shares may support a higher extraction of PBC which are less benign than idiosyncratic PBC. The controlling shareholder could simply steal or empire-build without accountability to investors – who would therefore be reluctant in the first instance to invest, or ask for an excessive discount. This suggests that the control afforded by dual class shares should be subject to certain limits in order to keep equity financing of enterprises viable.

If a controller non-opportunistically assigns an (idiosyncratic) value to the discount, investors, fearing that she will behave opportunistically, will demand a larger one or won't invest at all. Limits, for instance in the form of credible legal and/or reputational constraints on self-dealing, would prevent or minimize the chance of opportunism, thus permitting a desirable bargain to go forward. Second, a controller may, especially at some point mid-stream, after the corporation was created, overvalue idiosyncratic PBC and hence not be willing to sell her stake when doing so would be efficient. For instance, the controller may stubbornly fail to acknowledge the failure of her vision, or, as is not uncommon in Europe, her judgment may be compromised because she wants to pass her "legacy" to her offspring. Using this reasoning, Professors Bebchuk and Kastiel have recently argued that corporate law should impose mandatory sunsets on dual class shares.[231] Indeed, they argue more broadly that dual class shares may yield insufficient – and inefficient – accountability

---

proposal to cope with justification costs by way of dual-class recapitalization: managers will have to maintain some degree of ownership to make the recapitalization acceptable to institutional investors. See infra, text accompanying note 273.

[230] Pacces, "Control Matters", supra note 228.

[231] Bebchuk and Kastiel, "The Untenable Case", supra note 200.

of management (including for this purpose controlling shareholders). We respond to their argument in Section 4,[232] but for now, note only that while insufficient accountability is or may become a problem during a company's existence – indeed, it is the canonical problem focused on by those favoring more power for activist shareholders – excessive accountability, as we have argued, is or may become a problem as well. Sunsets may solve the problem of insufficient accountability, but they do not address the problem of excessive accountability. A 1S1V structure may become inefficient, in particular when the company would benefit from a more entrepreneurial management, but managers are stuck trying to get the leeway the company needs by means of defensive strategies. Because dual class recapitalizations are prohibited in the U.S. and are difficult to implement in other parts of the world, there seems to be no satisfactory private ordering solution to the problem of excessive, as opposed to insufficient, accountability.

Loyalty shares, to which we turn next, seem to provide a way out of this bind.

### ***Loyalty shares***

The debate over loyalty shares (also sometimes referred to as tenure voting) also reflects the international resonance of the long term/short term debate as we have framed it in this article. The shares potentially allow companies to reduce their accountability to investors in order to pursue a long-term strategy at some point in their lifecycle.

Sparked by the reincorporation of a major Italian carmaker – the former Fiat group, now known as Fiat Chrysler Automobiles (FCA)[233] – to the Netherlands, loyalty shares have become popular in Europe. Several jurisdictions, including Italy and the Netherlands, allow companies to opt into having such shares. In France, loyalty shares have been an option for a long time. However, since 2014, the Loi Florange has made loyalty shares the default regime for publicly held companies.[234] By contrast, in the U.S., investors are expressing increasing discomfort with deviations from 1S1V,

[232] See text accompanying notes 278-287.

[233] See supra, text accompanying notes 128-132.

[234] M. Becht, Y. Kamisarenka, and A. Pajuste, "Loyalty Shares with Tenure Voting—A Coasian Bargain? Evidence from the Loi Florange Experiment", ECGI Law Working Paper No. 398/2018, April 2018, available at http://www.ecgi.global/sites/default/files/working_papers/documents/finalbechtkamisarenkapajuste.pdf.

whether in the form of loyalty shares or dual class shares.[235] Loyalty shares resemble dual class shares, although they differ insofar as they are easier to introduce midstream, and they are somewhat less effective in entrenching management.

Loyalty shares are meant to reward long-term (typically two or three year) ownership, as defined by the company's charter (or by the legislator). The reward may be financial, such as a super-dividend or a warrant.[236] More often, however, the reward of loyalty shares consists in extra voting rights. The holders of loyalty shares for longer that the specified period will receive extra voting power, namely two or more votes per share, in the proportion set forth in the charter or by the law. Importantly, this benefit is linked to a minimum holding period. In one scheme (called "low-high") all the shareholders start with 1S1V. After holding their stock for the requisite period of time, the shareholders receive extra voting rights. These extra voting rights are not transferable, i.e., the stock reverts to 1S1V upon trading. This restriction allows loyalty shares to be implemented also with a "high-low" scheme, according to which all existing shareholders get super-voting rights, but the shares lose such rights once they are traded.

Loyalty shares tilt the balance of corporate power towards long-term shareholding, rewarding relatively long holding periods with higher voting power. Loyalty shares, it is argued, incentivize long-term investments. But is this true? Maybe not. First, long-term shareholding does not necessarily imply long-term decision-making.[237] Index funds are the paradigmatic long-term shareholders. But, as we discuss in Section 2, some evidence suggests that their voting may reflect non-long term interests, notably acceding to activist campaigns targeting underperforming companies, or favoring general policies for all of their portfolio companies that help them economize on the costs of deciding how to vote.

Second, it is hard to restrict loyalty shares to long-term owners: despite recent developments in technology,[238] beneficial ownership remains difficult to identify. Moreover, loyalty shares may be used strategically: having been a long-term

---

[235] See, e.g., Dallas and Barry, supra note 196; D. J. Berger, S. Davidoff Solomon, and A. J. Benjamin, "Tenure Voting and the U.S. Public Company", 72 *Business Lawyer* 295, 2017, available at https://www.wsgr.com/PDFs/TBL_72-2_01Berger.pdf. See also supra, text accompanying notes 194-209.

[236] P. Bolton and F. Samama, "Loyalty Shares: Rewarding Long-Term Investors", 25 *Journal of Applied Corporate Finance* 38, 2013, available at http://www.fir-pri-awards.org/wp-content/uploads/Article-P.Bolton-F.Samama.pdf.

[237] See supra, text accompanying notes 79-82.

[238] Berger, Davidoff Solomon, and Benjamin, supra note 235, at 312-315, have argued that the recent developments in technology, particularly in the use of blockchain, will help to screen for long-term shareholding effectively.

shareholder who supports long-term investment at one time does not necessarily commit to supporting long-term policies in the future.[239]

Loyalty shares do support long-term ownership. However, they do so by being attractive to controlling shareholders, who are credibly committed to maintaining ownership for an indefinite time and to making decisions based on this long-term horizon. Indeed, both in Europe and in the U.S., before loyalty shares were banned by the stock exchanges, controlling shareholders have always been the ones to cause the introduction of loyalty shares. While the controlling shareholders obviously qualify for the extra voting rights stemming from the length of their ownership, other investors qualify for the extra voting rights as well, something that is not the case for dual class shares. Thus, in principle, loyalty shares should be less attractive to controlling shareholders than dual class shares. This is especially so since other shareholders getting loyalty shares may be able to mount, or support, activist campaigns. However, the advantage of loyalty shares over dual class shares is that because the former treat all shareholders equally, they can be introduced by already-listed companies.

By contrast, introducing dual class shares may be difficult for 1S1V companies. Recall that dual-class companies are banned altogether from the UK Premium Listing. Although other European jurisdictions allow dual-class shares, in practice these cannot be introduced in midstream to enhance the power of controlling shareholders to the disadvantage of minority shareholders.[240] In the U.S., dual class recapitalizations treating existing shareholders disparately are likewise prohibited by the stock exchanges. Loyalty shares can be a good option to increase managerial leeway in midstream because they should not run afoul of these prohibitions: they do not discriminate among shareholders other than by reason of the length of time of their shareholding. Indeed, Professor Davidoff Solomon and his coauthors have argued that introducing them in midstream should be allowed notwithstanding that the introduction of tenure voting is cited by the NYSE as an example of prohibited

---

[239] C. Mayer, *Firm Commitment: Why the Corporation is Failing Us and How to Restore Trust in It* (Oxford University Press, 2013).

[240] In the Netherlands, for instance, dual class shares can be introduced in midstream with a shareholder vote – a vote in which the controlling shareholder may be determinative – so long as the multiple voting shares are distributed pro-rata, which defeats the goal of control enhancement. The telecommunication company Altice, for instance, reincorporated from Luxembourg to the Netherlands to introduce dual class shares in midstream. Super-voting Class B shares were distributed pro rata. The controlling shareholder (Patrick Drahi) expected noncontrolling shareholders to convert Class B shares into ordinary Class A shares, which were more liquid. This would have indirectly enhanced the voting power of the controlling shareholder to the extent that he would eventually be the only holder of Class B shares. This did not happen, however. Currently, Class A and Class B shares of Altice trade at about the same price on the Euronext market (i.e. they are equally attractive to investors).

recapitalizations.[241] As reflected in long-standing Delaware case law, the absence of discrimination allows the controlling shareholder to introduce tenure voting with a simple majority, without need for a majority of the minority to approve the transaction or for a court to review its entire fairness.[242]

Although loyalty shares do not formally distinguish among shareholders except as to the length of ownership of their shares, as a practical matter the qualifying holding periods of two or more years make loyalty shares less liquid than common stock. Loyalty shares are therefore generally not attractive to institutional investors. Institutional investors who hold shares for long periods of time may end up with higher voting power, but this may not be because of a strategic decision to do so. Index funds prioritize tracking indices accurately, so that the ability to timely exit from investments is crucial.[243] Because implementing their investment strategy requires them to be able to trade stock freely, in the aggregate they will benefit less from loyalty shares than controlling shareholders, who only sell stock when they can do so without losing control. Over time, just as is the case with dual class shares, loyalty shares will create an increasing wedge between the controlling shareholders' voting power and their ownership.

Unsurprisingly, institutional investors have opposed loyalty shares as much as they have dual class shares. However, unlike with dual class shares, they may be unable to stop the midstream introduction of loyalty shares. This is suggested by recent European experience with loyalty shares. In one instance, after the Loi Florange became effective, institutional investors opposed the introduction of loyalty shares in Renault, the state-controlled French carmaker. However, they failed to obtain the two-thirds majority required to opt out of the newly introduced default rule that provided for the introduction of such shares. In a recent paper, Professor Becht and his coauthors have shown that the controlling shareholder – in this case, the French state – has been able to introduce loyalty shares unilaterally in as many as 14 French listed companies, increasing its wedge between voting rights and ownership from 0.69% to 5.7% on average.[244]

---

[241] Berger, Davidoff Solomon, and Benjamin, supra note 235.

[242] Williams v. Geier, 671 A.2d 1368 (Del., 1996).

[243] A. Edmans and G. Manso, "Governance Through Exit and Voice: A Theory of Multiple Blockholders", January 18, 2009, available at http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.530.8824&rep=rep1&type=pdf.

[244] See Becht, Kamisarenka, and Pajuste, supra note 234, noting that it cost a billion Euro to increase voting power by 5% in one 1S1V company with a 20 billion euro market capitalization (such as Renault in 2015). The French government could achieve this result simply by changing company law.

The holders of loyalty shares are thus not the long-term institutional investors, but the controlling shareholders, who hold those shares to protect their tenure. But why have European controlling shareholders, who have managed to fend off hostile takeovers for decades, suddenly become interested in loyalty shares? The short answer is that hedge fund activism is on the rise in continental Europe,[245] and the presence of large shareholders holding a plurality of the voting shares – the classic European controlling shareholder – is not enough to make such activism toothless.[246] This is confirmed by the recent experience with hedge fund activism in a few European countries. For instance, activist hedge funds have been able to secure board seats in Italy, taking advantage of legislation mandating the appointment of directors representing minority shareholders.[247] In Sweden, which likewise has a tradition of controlling shareholders, a local hedge fund managed to successfully engage a number of companies controlled by the most prominent controlling shareholders of Sweden.[248] Importantly, in Europe as in the U.S., activist hedge funds need the implicit or explicit support of institutional investors to have any impact. In this respect, loyalty shares can only afford controllers limited protection from accountability to investors. If non-controllers held their shares for a sufficiently long period, even in the absence of a specific strategy to do so, with the extra voting power granted by their loyalty shares they could be able to outvote a controlling shareholder.

Whether, and under what circumstances, loyalty shares are sufficient to fend off shareholder activists is ultimately an empirical question, as to which there is as yet insufficient data. Professor Randall Thomas and his coauthors have recently conducted a theoretical simulation of different scenarios in which loyalty shares could play a role.[249] Their analysis reveals that loyalty shares are effective at protecting control only when the "inside" ownership – whether of the management or by controlling shareholders supporting them – is high (commanding more than 20% of voting power). (Interestingly, although loyalty shares are more effective in protecting control when ownership is 30% rather than 20%, the difference in the degree of protection is small, suggesting that loyalty shares could be a way for controlling shareholders to sell stock while maintaining control.) When the inside ownership is low (3%, for instance), the advantage of loyalty shares is limited. An

[245] See Activist Insight 2017, supra note 99; Activist Insight 2018, supra note 78.

[246] See supra, text accompanying notes 100-104.

[247] Belcredi and Enriques, supra note 100.

[248] See supra, text accompanying notes 105-107.

[249] P. H. Edelman, W. Jiang, and R. S. Thomas, "Will Tenure Voting Give Corporate Managers Lifetime Tenure?", ECGI Law Working Paper No. 384/2018, February 2018, available at http://www.ecgi.global/sites/default/files/working_papers/documents/finaledelmanjiangthomas.pdf.

important finding is that the lower the inside ownership, the higher the risk of being outvoted on account of a recommendation against management from a proxy advisor (ISS and Glass Lewis being the most influential such advisors). The impact of institutional investors blindly following ISS is comparatively lower in the presence of a controlling shareholder. However, the proportion of institutional investors voting independently as opposed to blindly following proxy advisors varies with context. There is some empirical evidence that ISS shifts at most 10% of votes in the US.[250] However, this is likely to vary considerably across jurisdictions, companies, and over time.

In conclusion, loyalty shares seem to be nearly as effective as dual class shares in protecting controlling shareholders from other shareholders' interference, provided that the controlling shareholder maintains substantial ownership (i.e. at least 20%). Loyalty shares are not as effective as dual class shares to protect managers. The big advantage of loyalty shares as compared to dual class shares is that loyalty shares can be introduced in midstream. However, this is also a disadvantage because, in some jurisdictions such as the U.S. and the Netherlands, the introduction of loyalty shares requires only a simple majority vote so long as shareholders are not treated disparately. As revealed by the European experience, this may enable controlling shareholders to increase the wedge between voting power and ownership unilaterally, i.e. even if a majority of minority (institutional) shareholders oppose it.

The foregoing has described the principal techniques, laws, and regulations that potentially help management defend against the advances of activist shareholders and others opposed to the managers' control or agenda: staggered boards, poison pills, antitakeover statutes (including constituency statutes), Section 13(d) of the Williams Act, dual class shares, and tenure (loyalty) shares. We have argued thus far that as they are presently used, these techniques do not sufficiently address the problem of justification-motivated decision making, which yields both agency costs and social costs. Section 4 sets forth and defends our proposal to address this problem.

## Section 4: Our proposal

### ***The proposal***

We propose a contractual solution. Managers and controlling shareholders should be able to negotiate with institutional investors for a CEM. We expect that this would

[250] Choi, Fisch, and Kahan, "The Power of Proxy Advisors", supra note 82, and text accompanying note 82.

most likely occur when managers determine that the business context that they are facing has become highly uncertain. Shareholders should have the right to approve or veto what management proposes. Management might simply propose CEMs for a set period of time. Or it might propose CEMs for a set period of time but terminable earlier if certain specified conditions are not met.

In order to mimic as much as possible the IPO setting – where CEMs can be introduced, with investors deciding whether to buy in or not – outside shareholders should have a veto right, for instance by way of a Majority of Minority (MOM) vote. The economic rationale for this veto right is that the management must offer investors something in exchange for the entitlement to control. In particular, managers or controlling shareholders can only hope to persuade shareholders to agree if the CEM is limited in time, compensation is paid, and/or there are countervailing measures, such as – for instance – board seats reserved to minority shareholders for as long as the CEM lasts or if certain results are not achieved.[251] We discuss some possibilities in this subsection, but we think companies and their shareholders should be able to craft, based on a set of stylized options, something that suits the company's particular needs and circumstances.

We think dual class shares are the best suited to achieve our proposal's goals. Companies should be able to engage in dual class recapitalizations explicitly. Dual class recapitalizations could confer upon the incumbent management sufficient voting power to fend off activists or hostile takeovers in exchange for any consideration agreed upon with (minority) shareholders. As discussed further below, our proposal runs counter to the current trend in the U.S. academic and policy debate, which is concerned with sunsetting existing restrictions on management accountability rather than introducing new ones in midstream.[252]

Our proposal does not reflect the state of the law in the United States or in Europe, which for various reasons make such a deal impossible as a practical matter. As mentioned, dual-class recapitalizations with voting stock are prohibited by the U.S. stock exchanges rules. In the UK, dual class companies are not even allowed to enter the Premium Listing to start with. Although some continental Europe jurisdictions, such as the Netherlands, allow dual class recapitalizations with a simple majority of

[251] Winden, supra note 207.

[252] See Bebchuk and Kastiel, "The Untenable Case", supra note 200; Sharfman, "A Private Ordering Defense", supra note 201; "Recommendation of the Investor as Owner Subcommittee: Dual-Class and Other Entrenching Governance Structures in Public Companies," February 27, 2018, available at https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac030818-investor-as-owner-subcommittee-recommendation.pdf.

the votes, shares of the new class must be distributed pro-rata, which defeats the control-enhancing purpose of dual-class shares.[253]

We believe the law should be changed to permit the introduction of such CEMs. Companies potentially benefiting from periods of insulation might otherwise go private or avoid valuable innovations, instead playing it safe; alternatively, companies seeking insulation might pursue broader insulation than they need or would be desirable if an alternative such as our proposal is not available.

Our proposal preserves many of the benefits of accountability while potentially reducing some of its burdens, notably the burden of justification costs. Compared to general curbs on shareholder activists – such as stricter rules on disclosing large stakes (such as shortening the time period, restricting acquisitions post-triggering the disclosure threshold, or even reducing the size of the threshold)[254] – our solution does not undermine hedge funds' incentives to engage poorly managed companies and provide feedback. We instead let the individual companies decide whether they benefit from exposure to hedge fund activism, or would prefer insulation from such activism in order to embark on a highly uncertain project. The onus is on the management and/or the controlling shareholder to persuade outside investors to approve the introduction of CEMs. In other words, we propose a pro-investor default rule. Our proposal thus differs from the solution in some jurisdictions of continental Europe, such as in France, where setting loyalty shares as the default has resulted in the unilateral redistribution of voting power from investors to controlling shareholders. Likewise, our proposal differs from other scholars' recommendations to set staggered boards – or their functional equivalents – as a default rule.[255]

On the contrary, we argue that 1S1V should be the default rule, whereas dual class shares would have to be opted-into. The law and economics literature has several criteria to identify desirable default rules. Majoritarian default rules save on transaction costs. Penalty default rules incentivize information revelation. None of this seems to be particularly relevant in the bargaining between professional managers and professional investors. More recently, Professor Ayres has suggested another criterion to determine the default-altering rule based on the cost of opting out. According to this criterion, the efficient default rule is made costly to opt out of (i.e. it's a "sticky default") in order to screen for the situation in which opting out is efficient. Only in the latter situation are the private benefits of opting out sufficient to

[253] See supra, note 240 and accompanying text.

[254] See supra, text accompanying notes 138-140.

[255] Cremers and Sepe, "The Shareholder Value of Empowered Boards", supra note 160.

offset the (social) cost of the non-default regime. Dual class shares reflect precisely this situation: they are economically efficient when the controller's PBC are higher than the cost to investors of holding noncontrolling stock (as reflected by the discount on noncontrolling stock).[256] If dual class shares were the default, however, they would be hard to opt out of even when the PBC were lower than the cost to investors. Because idiosyncratic PBC are, after all, unverifiable, it is easier for controllers to offer investors higher returns (a lower stock price) to opt out of 1S1V than for investors to offer PBC compensation to opt out of dual class shares. The same reasoning applies to the proposal by Professor Cremers and his coauthors to make staggered boards the default, particularly when the altering rules confer on the board – as their proposal suggests – a stronger veto than is currently the case.[257]

Already-listed 1S1V companies that want to opt into a lower accountability regime should face a slightly different default. In particular, dual class recapitalization should feature a default sunset clause. This default rule would save transaction costs, particularly, because it takes distributional concerns off the bargaining table.

By contrast with IPOs, the shareholders in an already-listed 1S1V company have their shares in a company that by definition has no CEM. In 1S1V companies, all shareholders have equal entitlement to a control premium. Introducing dual class shares in midstream shifts the entitlement to a control premium to controlling shareholders, something for which noncontrolling shareholders should be compensated. This compensation would correspond with the discount on noncontrolling stock in a dual-class IPO, which we discussed earlier: this is the price for the controlling shareholders' right to cash in their (idiosyncratic) PBC eventually.[258] In midstream, however, disagreement between managers and investors over the value of control will likely prevent such a deal from being made. More likely, parties will have to settle on a sunset clause. A sunset clause effectively prevents controlling shareholders from cashing in a control premium as the CEM is to expire in a number of years, and in any event, upon trading the controlling stock.[259]

By the same token, sunset clauses should not be imposed on existing, permanent dual class structures, unless this is agreed upon by controlling shareholders. Sunsetting existing dual class shares is equivalent to the promise to collapse them – that is, to reunify multiple classes of shares into one – at a future date. Imposing a sunset clause

---

[256] See supra, text accompanying notes 226-230.

[257] See supra, text accompanying notes 158-175.

[258] See supra, text accompanying notes 229-230.

[259] Winden, supra note 207, 51-52.

amounts to a redistribution from the controller to the noncontrolling shareholders. Whenever dual class shares are established without a sunset provision, reunification should be a voluntary decision and the law should facilitate, not prohibit, compensation for reunifying the shares into one class.[260]

Finally, in order to avoid a forced redistribution from controlling to noncontrolling shareholders, or vice versa, the existing regimes of dual class shares should be grandfathered. In practice, grandfathering is unlikely to play a major role because most jurisdictions already feature the regime we advocate as a default, to the extent that they allow opting out of 1S1V at all.[261] However, investors should have an effective veto on opting out of 1S1V if CEMs were initially prohibited. Conversely, controlling shareholders should have a veto on returning to 1S1V if – as in France – control enhancement is the default rule.

***A (less desirable) alternative***

As discussed above, law may present an obstacle to our proposal. Public companies in the U.S. may not conduct dual class recapitalizations except for issuances of nonvoting stock: dual class recapitalizations with voting stock are not permitted under stock exchange rules. For practical reasons, issuing nonvoting shares is only worthwhile for companies that already have a controlling shareholder (and perhaps supervoting shares).[262] That being said, dual class recapitalizations may be feasible using tenure voting structures (that is, loyalty shares),[263] which, as we noted above, are increasingly common in Europe, where, likewise, there are restrictions on dual-class recapitalizations.[264] Although time-phased voting would seem to fall within the U.S. stock exchange prohibitions, structuring such voting may be possible. In particular, in order to pass muster under existing law, extra voting rights would be

[260] Ibid., 54.

[261] The gist of our proposal is, indeed, that corporate law should allow publicly held companies to enter dual class recapitalizations with a MOM vote.

[262] Issuing nonvoting shares indirectly enhances the voting power of a controlling shareholder, if there is one. Managers, however, would have to issue supervoting shares to themselves in order to enhance their voting power sufficiently. Note, in addition, that the law of Delaware allows dual class recapitalizations upon a simple majority vote, which under-protects investors especially in the presence of a controlling shareholder. A company not listed on an exchange and incorporated in Delaware could in theory engage in dual-class recapitalizations with both voting and nonvoting stock. See supra, text accompanying note 242.

[263] Berger, Davidoff Solomon, and Benjamin, supra note 235.

[264] Recall that dual-class shares are banned from the UK Premium Listing, whereas other European jurisdictions either prohibit the midstream introduction of supervoting shares or make such recapitalizations unsuitable for control-enhancing purposes. See supra, text accompanying note 253.

allocated based on the holding period without discriminating among shareholders. This is precisely the way in which loyalty shares have been introduced in various European jurisdictions, either by way of legislation, private ordering, or both.

Absent a change in the law, loyalty shares offer an advantage over other alternatives. As noted above, loyalty shares can be introduced in midstream while dual class shares cannot – at least, not in ways that allow the management or the controlling shareholder to directly enhance their voting power.[265] Formally, tenure voting/loyalty shares immediately confer upon every shareholder extra voting rights (or the expectation thereof) in proportion to their stake. Crucially, however, the shareholder who sells her shares before a certain number of years loses the extra voting rights (or fails to get them). But not all shareholders are similarly situated: While the logic underlying tenure voting is to reward the loyalty of long term investors, this logic neglects the economics of institutional stockholdings, which reveals that liquidity and governance (via both exit and voice) are complements, not substitutes.[266] Because institutional owners cannot commit to whichever holding period is necessary to qualify for extra voting rights, the latter will benefit only the management or the controlling shareholders who introduced the loyalty shares to start with – most other investors will trade them eventually. Thus, although in theory noncontrolling shareholders also qualify for loyalty shares, in practice the CEM will increase the controlling shareholder's voting power, as many of the other shareholders sell their holdings and hence lose their loyalty shares.

Loyalty shares therefore are not ideal for the purpose we envisage, to enable managers and controlling shareholders to contract with investors for the desired leeway. As revealed by the European experience with such structures, loyalty shares can be introduced unilaterally by the controlling shareholders, particularly if the latter is the state, without giving institutional investors any real say. Should the shares pass the scrutiny of the exchanges in the U.S., they could likewise be introduced midstream by way of a simple majority vote. A controlling shareholder could thus introduce tenure voting unilaterally in the U.S. as well, short of a change in Delaware law, insofar as the law presently allows altering the securities voting structure without further scrutiny by courts and/or by a Majority of Minority

[265] See supra, text accompanying notes 240-242.

[266] Edmans and Holderness, supra note 88.

shareholders.[267] Professors Bebchuk and Kastiel have recently advocated such a legal change.[268]

The dual class recapitalization that we advocate fares much better. Because the transaction by which the company comes to have a CEM would entail the dilution of existing stock, something that is currently prohibited, management would presumably have to pay something for the supervoting stock to be issued to them and, because they have a conflict of interest, the transaction would have to be validated by a MOM vote giving institutional investors the veto right that we advocate. In this way, institutional investors would enjoy the protection of a property rule as at the IPO stage.[269]

We expect – although we would by no means require – dual class recapitalizations to be combined with a sunset clause. While a sunset clause enables the holders of supervoting stock to pursue their vision unimpeded for as long as the restriction is in place, it makes dual class shares distributionally neutral because, as is typically specified in a sunset clause,[270] controllers would lose the entitlement to supervoting rights upon trading their stock. Consequently, controllers could not cash in idiosyncratic PBC by selling control to a third party. That controllers cannot secure a control premium should make a midstream introduction of the CEM easier for institutional investors to accept.

In conclusion, dual class recapitalizations enable managers and controlling shareholders to negotiate with institutional investors for CEMs in midstream. Outside shareholders would have a veto right on the restriction, as they do in the IPO setting, when they decide whether to invest in dual class shares companies that are selling shares to the investing public for the first time. In midstream, this veto right could be operationalized by way of a majority of the minority (MOM) vote. The incumbent management would have to persuade investors accounting for a majority of the minority to agree on how long the management's special rights would last, and any extra rights that would be granted to minority shareholders during that time, such as a certain number of seats on the board. Although all shareholders, including both

[267] Williams v. Geier, 671 A.2d 1368 (Del., 1996).

[268] L. A. Bebchuk & K. Kastiel, "The Perils of Small-Minority Controllers", forthcoming, *Georgetown Law Journal* (last updated April 9, 2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3128375, at 50.

[269] Note how we disagree with Zohar Goshen & Assaf Hamdani, who argue for a liability rule sort of protection (Goshen and Hamdani, supra note 226, at 610-11). Here we note that, at the IPO stage, investors do not have to buy into dual-class companies (albeit at a discount) if they do not want to.

[270] Winden, supra note 207.

individual and institutional investors, would be entitled to vote, we would expect that voting would mainly be done by institutional investors,[271] whose stakes make taking the trouble worthwhile.[272] A MOM vote thus effectively confers upon institutional investors a veto right on the management's proposal to enter into a dual-class recapitalization.

***<u>What Might Management Propose? Some Thoughts</u>***

One mechanism that might be considered is a class of stock akin to preferred stock, where, unlike the typical preferred stock, the preference was as to voting rights rather than dividends. Managers (and/or controlling shareholders) could be entitled to purchase supervoting shares sufficient to fend off shareholder activists and hostile takeovers. (In jurisdictions other than the U.S. there may be functionally equivalent ways to achieve the same result.). The class of stock could convert into common stock at some point, on terms to be negotiated. The (institutional) investors effectively would dictate the price of the grant of extra voting power to the management or controlling shareholders so long as they have a veto right on the proposal. This implies setting the insiders' ownership (and consequently, the wedge) at levels which make the proposal acceptable to institutional investors.[273] The issuance could require a MoM vote, and its terms could be required to reflect input from a Special Committee (SC) of independent directors. In this regard, a dual class recapitalization implemented by way of preferred stock (or otherwise) implies a similar conflict of interest as a going private transaction, which suggests that the legal regime should be similar.[274]

There is, however, an important difference with a company that goes private: the company entering into a dual class recapitalization remains a public company. This fact affects the negotiations. Because the institutional investors are not selling their shares (as they would be doing if the company was going private), in all likelihood the grant of extra power would have to be temporary. This is to say, we expect that a dual

[271] In general, individual investors' stakes are too small to make it worthwhile for them to vote. Edmans and Holderness, supra note 88, at 546.

[272] See Gilson and Gordon, supra note 53. See also supra, text accompanying notes 77-87.

[273] See supra note 229 and accompanying text (discussing the importance of ownership as commitment device in dual-class IPOs).

[274] In re MFW Shareholders Litigation, 88 A.3d 635 (Del. 2014). We agree with Bebchuk and Kastiel, supra note 268, that this should be the standard that governs midstream control enhancements. See also Pacces, "Procedural and Substantive Review of Related Party Transactions (RPTs)", supra note 197.

class recapitalization would include a sunset clause. Continuing the preferred stock example, the controllers would likely convert their shares into common stock at the date and the ratio agreed upon, reflecting the amount they paid to purchase the shares. This would allow controllers and investors to share in the profit stemming from the controller's vision. Or, the sunset clause could be extended in another MOM vote adequately informed by the SC advice if the controller managed to persuade investors that they needed more time. In any event, the length of the restriction would have to be finite for distributional reasons. The right to control a company indefinitely includes the entitlement to a control premium. Introducing dual class shares in midstream implies transferring this entitlement from the investing public to the controllers. Disagreement about the value of control of an already listed company is likely to make such a transfer impossible. Sunset clauses, on the other hand, can make CEMs distributionally neutral.

Note how this is different from an IPO situation. Companies often go public with 'perpetual' dual class shares structures, having no sunset. This is increasingly controversial in academic and policy debates.[275] However, as we explained in the previous Section,[276] the investors' decision to buy into such structures (at a discount relative to 1S1V structures) reflects an implicit agreement between the founders and public shareholders about the prospective value of control. Therefore, we argue that sunset clauses should not be mandatory, although they are likely to be introduced by private ordering along with a dual-class recapitalization.

Sunset clauses are only one example of the type of term we envision in order for institutional investors to allow managers and controlling shareholders some leeway from justification (and thus, from activist shareholders). In order to persuade shareholders to approve the (temporary) restriction on their voting power, or to allow managers to pay a lower price than they otherwise would for the supervoting rights, the management might specify certain financial results or other kinds of measurable indicators which, if not met, could trigger early conversion (possibly at a penalty rate) into common stock (and hence termination of the extra voting rights). By the same token, for as long as the "preferred stock" was outstanding, the agreement between the controller and institutional investors could include board representation for the latter, to reduce monitoring costs. Board representation (or more board representation) could also be conditional on the company's results: for

[275] Bebchuk and Kastiel, "The Untenable Case", supra note 200.

[276] See supra, text accompanying notes 226-230.

instance if certain financial results were not met within a given time, institutional investors could be given the right to have greater representation on the board.

Why would institutional investors enter into this kind of contractual agreement? After all, institutional investors are the arbiters of most, if not all, the prospective engagements by shareholder activists.[277] They might prefer case by case decision-making, where they could appraise activist campaigns on their individual merits. The contractual solution we advocate allows the institutional investors to credibly commit to a long-term perspective as envisioned by the management and reflected by the proposed length and terms of the CEM. This approach could be particularly valuable for index fund managers, which do not have the resources to screen the merits of individual campaigns and hence are apt to develop a standardized strategy for use in all activist shareholder campaigns.

### ***Addressing Some Contrary Views***

We argue above for dual class structures that could be permanent if management was able to obtain shareholder approval. By contrast, Professors Bebchuk and Kastiel have recently argued that permanent dual-class shares structures should be prohibited – or, to put it differently, dual class shares should include a mandatory sunset clause.[278] Their argument is that the only defensible justification for dual class shares is the superior talent of the founder who introduced them. This advantage – the argument runs – recedes over time, which is reflected in the fact that dual class companies trade at a discount compared with single class companies. Indeed, controlling shareholders do not have incentives to collapse a dual class structure when such a structure becomes inefficient.

A recent empirical study of U.S. dual class shares companies might seem to provide support for Bebchuk's and Kastiel's argument.[279] Such companies initially outperform their single-class peers in a matching sample on every performance measure, but this advantage seems to disappear with time. On average, after 6 to 9 years, dual class shares companies – which have not, meanwhile, reunified their shares – underperform their peers. Note, however, the limitations of this study. First, the research acknowledges that the negative performance reflects factors others than time, notably including the increase in the wedge between voting power and

[277] See supra, text accompanying notes 77-87.

[278] See Bebchuk and Kastiel, "The Untenable Case", supra note 200, and text accompanying notes 231-232, supra.

[279] Cremers, Lauterbach, and Pajuste, supra note 205.

ownership over the years. Whatever motivates the increasing wedges (for instance, family ownership, which we discuss below), higher wedges disincentivize dual class reunifications, particularly when such reunifications are efficient. Second, according to the same study, the evidence that that dual-class firms underperform their peers after 6-9 years is not consistent across performance measures.[280]

Although Bebchuk's and Kastiel's concern is a legitimate one, their argument goes too far.[281] To begin with, the existing empirical analyses of dual class shares companies do not take into account the effect of family ownership, which, according to another recent study, is the real reason why the performance of controlled companies decreases with time.[282] This finding accords with the intuition that founders cannot transfer their talents in a succession. CEMs do not make this problem worse, at least insofar as controllers cannot unilaterally increase the control enhancement.

Secondly, the claim that dual class shares are irreversible is exaggerated. Both in the U.S. and in Europe, dual class structures are sometimes collapsed. Particularly in the United States, such dual class unifications may be accomplished by compensating controlling shareholders.[283] This is because controlling shareholders can sell their stake for a premium over non-controlling stock, something that cannot be done in Europe because of the rules on mandatory bids, which effectively prohibit control premiums.[284] Critically, dual class structures can be collapsed by compensating

---

280 In particular, as opposed to Tobin Q, the Total Q of dual-class firms does not decrease significantly compared to single-class peers, even after 9 years. Total Q reflects better the performance of firms with intangible capital. See Cremers, Lauterbach, and Pajuste, supra note 205, at 25. See also C. Doidge, K. M. Kahle, G. A. Karolyi, and R. M. Stulz, "Eclipse of the Public Corporation or Eclipse of the Public Markets?", ECGI Finance Working Paper No. 547/2018, January 2018, available at http://www.ecgi.global/sites/default/files/working_papers/documents/finaldoidgekahlekarolyistulz.pdf.

281 The argument by Bebchuk and Kastiel in favor of mandatory sunsets fundamentally rests upon the assumption that: a) the control premium cannot be cashed in; b) IPO investors accepting permanent control enhancement are shortsighted. We contest both claims. As far as the control premium is concerned, in the US a controlling shareholder is free to sell its shares for the price she deems fit. She could not force minority shareholders to sell, too, at a lower price (Goshen and Hamdani, supra note 226), but this does not rule out the payment of a control premium. More broadly, the absence of compensation in dual class reunifications is often asserted, but apparently rarely occurs. Winden, supra note 207, at 54, reports 2 cases in which the holders of high-vote shares received a compensation for reunification. Likewise, the claim that IPO terms are not priced by investors is often made, but rarely proven. That IPO investors are market professionals makes this claim counterintuitive. As we discuss below, the fact that institutional investors seek to sunset dual class shares after having bought them may reflect distributional considerations.

282 R. Anderson, E. Ottolenghi, and D. Reeb, "The Dual Class Premium: A Family Affair", working paper, Aug. 14, 2017, available at https://ssrn.com/abstract=3006669.

283 Winden, supra note 207.

284 In the European Union, the Takeover Bids Directive (2004/25/EC) compels acquirers of stakes larger than 30% (or one third, depending on the jurisdiction) to make a general offer to the other shareholders at the highest price paid for the controlling shares. See Enriques, Gilson, and Pacces, supra note 217, at 100, for the impact of this rule on efficient and inefficient sales of corporate control. Such a rule does not exist in the U.S.,

controlling shareholders. From this standpoint, the increasing insistence by institutional investors that public companies collapse or sunset existing dual class structures seems like a redistribution request. As explained previously, the motivation for holders of supervoting shares to part with control is to cash in their idiosyncratic PBC upon selling their stake. This allows controllers to obtain a reward on their investment in entrepreneurship. Similarly, the compensation controllers may receive for agreeing to collapse a dual class shares structure reflects such a reward. Whenever shareholders are able to compensate the controller for introducing more accountability, dual class shares need not be as permanent as they look. Collectively, investors compensating controlling shareholders for collapsing a dual class structure midstream are paying back the discount they received at IPO.

Furthermore, note that the price investors will pay to reunify dual class shares will not necessarily remain constant. Particularly when the controlling shareholder realizes that her contribution to the company's success is limited (for instance, because of age or difficulties with succession), the compensation will likely be small.[285] There will surely be frictions impeding the ability to come to an agreement, especially if the controlling shareholder is overoptimistic about the value of control or is only able to consume PBC inefficiently – for instance, by way of expropriation or empire building.[286] However, unless the controller is allowed to increase the wedge between control and ownership, for instance by unilaterally awarding loyalty shares or introducing other CEMs, inefficient PBC consumption will be constrained by the legal and contractual safeguards accompanying the original limitation of accountability (and reflected by the size of the discount on noncontrolling stock). Overoptimism about the value of control, on the other hand, is likely to be short-lived. A mismanaged company will eventually do so poorly that it will need external finance, which the financiers will only provide on condition that more accountability is established. Ultimately, managerial accountability will be reintroduced when it is efficient to do so.

We therefore disagree with Bebchuk and Kastiel that dual class shares warrant regulatory limitations, particularly concerning the length of the period for which such shares should be allowed. Whether dual class shares established at IPO are temporary or permanent should be decided by private ordering. Indeed, IPO

---

where there are fewer constraints on controlling shareholders' receipt of a control premium. See generally Goshen and Hamdani, supra note 226, at 604ff and E. B. Rock, "MOM Approval in a World of Active Shareholders", ECGI Law Working Paper No. 389/2018, March 2018, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3122681, at 4-5.

285 Gilson, "Controlling Shareholders and Corporate Governance", supra note 224.

286 See supra, text accompanying note 231 (overestimation of idiosyncratic PBC).

companies with dual class shares often include voluntary sunsets.[287] While, as we argued, listed companies will eventually collapse dual class structures when such structures have become inefficient, we are skeptical that listed companies can introduce dual class shares when they become efficient. The management of a publicly- held company seems to be unable to negotiate limitations on accountability with shareholders even when these limitations are needed to support entrepreneurship in corporate governance. Indeed, more generally, we worry as much about controllers facing what we have called excess accountability when they would like to be more entrepreneurial as about shareholders facing difficulties in eliminating existing restrictions when such restrictions are no longer efficient and the company would benefit from short-term feedback. Paring back restrictions of accountability is not difficult, at least not as a legal matter. For instance, takeover defenses may be dismantled and dual class shares structures may be collapsed (i.e. the classes reunified) so long as the beneficiaries of the restriction – the controllers (managers or controlling shareholders) – agree. By the same token, law should facilitate limiting accountability whenever the beneficiaries – the noncontrolling shareholders – agree.

***<u>Our bottom line</u>***

In the highly polarized policy debate on the allocation of power between shareholders and management, the purists in the respective camps argue that one single solution is efficient. That is to say, according to the 'shareholder advocates', management should *always* be accountable to shareholders; on the contrary, according to the 'insulation advocates', this should almost *never* be the case. (This may overstate the case, but only slightly.) Because both approaches neglect uncertainty, they also overlook the fact that entrepreneurs seeking funding and investors seeking good ideas to finance are well situated to agree on the power allocation that suits them best. We expect that they will be particularly inclined to do so when the business faces considerable uncertainty. [288]

---

[287] Council of Institutional Investors, "Time-Based Sunset Approaches to Dual-Class Stock" (chart showing 19 IPO companies and their sunset provisions, 2010-2017), 2017, available at https://www.cii.org/files/2-14-18%20Time-based%20Sunsets.pdf.

[288] These two approaches have been likewise criticized by J. A. McCahery, M. Hisatake, and E. P. M. Vermeulen, "The Present and Future of Corporate Governance: Re-Examining the Role of the Board of Directors and Investor Relations in Listed Companies", 10 *European Company and Financial Law Review* 117, 2013, also available in an earlier version as ECGI Law Working Paper No. 211/2013, May 2013, available at https://ecgi.global/sites/default/files/working_papers/documents/SSRN-id2254520.pdf. These authors

Shareholder advocates claim that any degree of insulation of management from shareholders' intervention is inefficient because it increases agency costs.[289] They would prohibit staggered boards and other enhancement mechanism that could entrench management and thereby allow it to continue to pursue bad ideas and enrich itself.[290] In specific contexts, such as takeovers or shareholder activism, this contention is sometimes tempered by the observation that agency costs can also stem from different sources, that is to say an *acquirer's* empire building or an activist's short-termism.[291] Such qualifications are usually considered of an insufficient order of magnitude to support management insulation.[292] Agency cost, however, also stems from the need to justify to investors that are in turn agents of retail investors. Managers who are accountable to institutional investors will seek short-term performance or otherwise make conventional decisions that can be justified in the event of a bad outcome. While in some situations this is the best way to maximize shareholder value, in situations of high uncertainty it is not. Therefore, even within the realm of agency costs, the case for shareholder empowerment across the board is not theoretically straightforward. Most important, the claim that management accountability is the obvious solution to the corporate governance problem is hard to reconcile with a reality in which a sizeable minority of companies in the United States, and the vast majority of companies around the world, choose the opposite solution.

Insulation advocates fare no better. Some scholars have argued that staggered boards should become a quasi-mandatory rule.[293] Similarly, insulation advocates welcome dual-class and loyalty shares.[294] Some commentators would even use legislation – in particular, making Section 13(d) stricter – to curb the activists' ability to profit from engaging the management of public companies, insofar as the knowledge of their

---

argue that implementing a well-functioning governance structure, and adapting it to the pursuit of "sustainable" (long lasting) growth and value creation over time, should be the exclusive responsibility of individual companies in consultation with their institutional investors. McCahery, Hisatake, and Vermeulen's view, which is similar to ours, is based on a multi-dimensional approach to corporate governance, combining control of managerial behavior, long-term investment, and economic growth.

[289] L. A. Bebchuk, "The Myth That Insulating Boards Serves Long-Term Value", 113 *Columbia Law Review* 1637, 2013.

[290] Bebchuk and Cohen, "The Costs of Entrenched Boards", supra note 166.

[291] R. J. Gilson & R. Kraakman, "Takeovers in the Boardroom: Burke versus Schumpeter", 60 *Business Lawyer* 1419, 2005. See also Hill and McDonnell, "Short and Long Term Investors", supra note 22.

[292] See M. J. Roe, "Corporate Short-Termism—In the Boardroom and in the Courtroom", 68 *Business Lawyer* 977, 2013, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2239132##.

[293] Cremers and Sepe, "The Shareholder Value of Empowered Boards", supra note 160.

[294] See, e.g., J. Fox and J. W. Lorsch, "The Big Idea: What Good Are Shareholders?", *Harvard Business Review*, July-Aug. 2012, 56-57; see also Mayer, supra note 239 (who, however, argues in favor of a contractual mechanism, as we do).

interest in and anticipated engagement of the company should raise the purchase price for their own initial stake.[295] The key argument used by insulation advocates is based on the superiority of managers' information to that of shareholders. Because managers know better how to run the business, shareholder intervention can only be motivated by opportunism.[296] Specifically, activist shareholders (as well as takeover bidders in the past) seek to extract benefits that are not shared with the other shareholders. In a sense, this claim is stating the obvious: public shareholders need to secure private benefits from intervention in order to overcome free riding. But the claim that insiders always know better than outsiders is implausible on its face. Insiders can behave opportunistically too, or simply be wrong. Introducing innovation and uncertainty into the picture does not change this observation. All companies have to innovate in order to survive, and the odds of successful innovation cannot be estimated with precision. The length of a company's innovation cycle will significantly determine whether companies benefit from a regime of more or less accountability to investors. Again, empirical evidence in the United States, as well as in other developed stock markets, offers examples of both types of arrangements.

The varying degrees of management accountability that we observe are in principle neither too low nor too high. The accountability we observe in corporate governance normally reflects an agreement between the company's founders and IPO investors, which, as we have seen, should have been efficient at the time the IPO took place. However, this initial agreement may later become outdated because companies face varying degrees of uncertainty during their (they hope, long) existence.[297] For instance, some companies for which dual class shares were initially efficient might later benefit from the higher accountability stemming from 1S1V. Also, the initial arrangement may be altered unilaterally by one of the parties. For instance, a controlling shareholder may increase the wedge between voting power and ownership, as the French state recently did.[298] There are also examples in the other direction, such as the campaign by institutional shareholders to de-stagger the boards of U.S. public companies, including for instance by threatening to withhold voting support for directors at annual elections.

[295] See, e.g., Coffee, "The Agency Costs of Activism", supra note 85; J. C. Coffee, Jr., "Preserving the Corporate Superego in a Time of Activism: An Essay on Ethics and Economics", working paper, September 16, 2016, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2839388; Coffee and Palia, supra note 30.

[296] There is an alternative on this view, but it fares no better, and supports management insulation - that shareholders think they have a better idea but are mistaken because of their comparative informational disadvantage.

[297] McCahery and Vermeulen, "The 'Ignored' Third Dimension of Corporate Governance", supra note 223.

[298] See supra, note 234 and accompanying text.

The efficient arrangement concerning the allocation of powers between shareholders and management varies across companies, and with time, because the uncertainty they face calls for different degrees and frequency of justification. There is always a simple – albeit not costless – way for entrepreneurs to avoid justification to shareholders and markets, which is to keep or take the company private. Conversely, the simple way to maximize the proceeds from going public is to make management fully accountable to shareholders. Companies choosing full or limited accountability do this for a reason. For these initial arrangements to remain efficient over time, two conditions must be met. First, outside shareholders should be protected from unilateral actions by the management or the controlling shareholder—that is, by means of fiduciary duties or functional equivalents, investors should be protected from expropriation.[299] Second, managers and controlling shareholders should be able to negotiate adaptations of the existing accountability arrangement with shareholders – that is, controllers should be able to contract for insulation from shareholder intervention.[300] The adaptation of existing arrangements as to management justification to investors is difficult in midstream, when companies are already publicly held. Managers or controlling shareholders may try to take advantage of investors; likewise, the latter may seek redistribution from the former. Our proposal provides a solution to this problem.

## Section 5: Some applications in finance

Thus far, we have principally considered corporate governance and in particular, the allocation of power between managers and shareholders. We have argued that managers' anticipated need to justify their decisions can yield agency and social costs. Our account also considered the extent to which shareholders themselves (and their financiers) had to justify their decisions.

We think that justification-motivated decision-making is potentially problematic in other realms as well. Justification is not just to other market participants. Market actors are also potentially accountable to legal authorities. There will often be significant overlap in what serves as justification in the market and under law, since legal authorities will often look to the standard among peers in order to evaluate the conduct of the agent, and the standard among peers will often be informed by what law requires or favors as the agent's conduct. But law has its own constraints and

---

[299] Kraakman et al., *The Anatomy of Corporate Law*, supra note 90, 145-169. See also supra, text accompanying notes 267-268.

[300] Pacces, *Rethinking Corporate Governance*, supra note 118, at 216-217.

concerns. In particular, as we explain below, the need for lawmakers, including regulators, to justify themselves may add another level of complexity to the mix.

Regulators may be slow to revisit regulations: justifying staying with the status quo is typically far easier than justifying something new. This effect complements another familiar effect: interest groups who are about to become worse off can bring considerable pressure to bear.[301] Importantly, in financial regulation, the latter effect is procyclical. The impact of financial industry's lobbying on regulation is strongest during market booms, when the case for curbing finance is hard to make to the public. Interest groups are less influential in a downturn, when the public is alert to financial crises and the crises' adverse effects on daily life. As a result, financial regulation tends to be overly lenient during expansions, and overly strict during recovery.[302]

That financial regulation is pro-cyclical is a well-known problem. But the need for policymakers to justify their decisions under conditions of uncertainty plays an important role in it. Similar to the case of managers of a public company, regulators anticipating needing to justify their actions will tend to 'play it safe' instead of being entrepreneurial.[303] This implies 'conventional' decision-making, failing to introduce curbs on banking when they may prevent a financial crisis or introducing such curbs when they may delay a recovery.

One example is the Federal Reserve's failure to update the capital requirements of banks to reflect the massive use of Credit Default Swaps (CDS) in the years preceding the global financial crisis.[304] At some point – well before September 2008 – it was clear that American International Group (AIG) was insuring a substantial part of the U.S. banking system against the default of the then-outstanding mortgage backed securities. Regulators chose to allow this vulnerability of the banking system to continue, something that eventually harmed society. This decision was justified by the rules on counterparty risk at the time. Choosing an alternative course of action would have required requesting an update of the capital requirements rules, which is costly to justify – to peers, interest groups, and the public that ultimately benefits from an economic boom – when it is uncertain that the protection of additional capital will ever be needed.

---

[301] J. A. den Hertog, "Economic Theories of Regulation", in R. J. van den Berg and A. M. Pacces, eds., *Regulation and Economics* (Edward Elgar Publishing, 2012), 25-96.

[302] M. K. Brunnermeier et al., *The Fundamental Principles of Financial Regulation* (Centre for Economic Policy Research (CEPR), London, UK, 2009).

[303] See Knight, supra note 12, at 361.

[304] R. Levine, "The Governance of Financial Regulation: Reform Lessons from the Recent Crisis", 12 *International Review of Finance* 39, 2012, https://doi.org/10.1111/j.1468-2443.2011.01133.x.

The bias stemming from policymakers' need to justify can and does go in the opposite direction. The mantra of financial regulation after the global financial crisis has been that banks should hold more, and higher quality, capital.[305] This is a justified reaction to the excessive risk-taking by overly leveraged banks in the years preceding the global financial crisis. Capital requirements, however, are not costless. Firstly, imposing higher capital requirements on banks limits their lending capacity, which might be undesirable at a time when the economy is recovering from a financial crisis.[306] Secondly, whereas higher bank capital is no panacea for financial stability, it may create an illusion of safety and lead to more regulatory arbitrage as well.[307] Again, adapting capital adequacy requirements to the varying economic circumstances would be preferable, but this is too costly to justify under uncertainty about the future. As a result, in the aftermath of the global financial crisis, banking regulation has mainly focused on enhanced capital requirements.[308]

This example illustrates how the perceived need to justify oneself affects the decisions of policymakers. Accountability of policymakers can be compared and contrasted with accountability of corporate managers. By contrast with market participants, who, as principals, are serving their own interests, or, as agents, are serving their principals' interests, lawmakers are supposed to be serving the "public interest." But, as is well known, policymakers, while in theory only serving the society's best interests, are also self-interested. Their incentives will be aligned with the interest of those constituencies (including the financial industry's lobbyists) on which the policymakers' position and status ultimately depends. Thus, that policymakers need to justify their actions is desirable to promote accountability to the "real" principals, namely the citizens of a given country. As in the principal-agent setting of market participants, standardization of justifications is also beneficial because it reduces monitoring costs. For example, a straightforward increase of the capital requirements of banks is far easier to explain to the public than is a countercyclical fine-tuning of the risk weights of specific classes of assets. The former

---

305 See the Basel III standards at https://www.bis.org/publ/bcbs189_dec2010.htm.

306 R. J. Caballero, "Sudden Financial Arrest", MIT Department of Economics Working Paper No. 09-29, 2009, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1504985.

307 R. S. Kroszner, "Stability, Growth and Regulatory Reform", 16 *Banque de France Financial Stability Review* 87, 2012, at 89-90, available at https://pdfs.semanticscholar.org/a08c/7d2a6729ff6f8bc6da9d5b164d15868e7d09.pdf.

308 To be sure, Basel III includes a countercyclical capital buffer. See BIS, "Guidance for National Authorities Operating the Countercyclical Capital Buffer", https://www.bis.org/publ/bcbs187.htm. Note, however, that the national banking authorities enjoy limited discretion in setting this buffer and, more important, the whole set of Basel III rules (including the countercyclical buffer) apply only to official banks. On the limits of this approach to promoting financial stability, see Nabilou and Pacces, "The Law and Economics of Shadow Banking", supra note 19.

can be explained by reference to the readily accessible concept of moral hazard; the latter defies accessible explanation. The former is easier to monitor than the latter.[309]

Justification thus plays a beneficial role, in limiting the agent's discretion and hence her ability to act in a self-serving manner, including being captured by interest groups. However it does so by encouraging or even requiring the agent to act in a way that we cannot know is desirable given uncertainty. Returning to the previous example, uncertainty makes the "right" amount of capital that banks should maintain for purpose of financial stability impossible to determine. Still, the requirement of justifiability of policy intervention according to the conventional wisdom may, at precisely the wrong time, lead to actions– such as policing moral hazard when banks face a liquidity crisis and thus need support rather than punishment – instead of actions that, at that time, would make more economic sense but are costlier to justify.

A major complication in policing financial instability is that anti-cyclical policies go against the received wisdom supporting the status quo.[310] This problem is exacerbated by justification, which draws on the received wisdom. Requesting banks to hold more capital in good times will upset the banking lobbies precisely when the facts seem to support their views that restrictions are unnecessary. This makes it difficult for policymakers to justify unconventional curbs. On the other hand, relaxing the capital requirements in bad times appears to serve the interest of the lobbyists exactly when their views are weaker in the eyes of the public. This makes it difficult for policymakers to justify actions supporting rather than curbing the banks.

As in corporate governance, while a justification requirement seemingly improves principal-agent relationships by reducing the cost of monitoring the agent, in fact the same requirement may cause the agent to underperform whenever there is substantial uncertainty and the decision that is easier to justify is not necessarily the best one for the principals.[311] An attempt to limit discretion in order to limit agency

---

[309] For example, straightforward capital requirements, such as simple leverage ratios are cheaper instruments to monitor banks than complex ratio based on risk weights. Arguably, simpler instruments are more effective at countering regulatory arbitrage. This is confirmed by the EU experience with the implementation of Basel III, which reveals that a straight leverage ratio – albeit significantly less demanding than the comparable restriction in the U.S. – is more binding that enhanced capital requirement based on risk weights. See EBA, "EBA Publishes Results of the CRDIV-CRR/Basel III Monitoring Exercise as of 31 December 2015", Sept. 13, 2016, https://www.eba.europa.eu/-/eba-publishes-results-of-the-crdiv-crr-basel-iii-monitoring-exercise-as-of-31-december-2015, particularly considering regulatory arbitrage. However, as we discuss below, inflexible regulatory instruments have also unintended consequences. See D. Duffie, "Financial Regulatory Reform After the Crisis: An Assessment", forthcoming, *Management Science*, published online August 3, 2017, https://doi.org/10.1287/mnsc.2017.2768.

[310] Brunnermeier et al., supra note 302, at 66-69.

[311] More broadly, this way of dealing with uncertainty yields the potential for significant agency costs in relationships such as those between money managers and investors and government officials doing

costs of one sort turns out to potentially yield such costs of another sort. Again, this is true for market participants and for those involved in ensuring that regulations are enforced, including the policymakers having the discretion to intervene to deflate a bubble or give market participants the flexibility to recover from a slump.

The prominent role of uncertainty in the regulation of financial markets makes this context somewhat special. Uncertainty is the quintessence of financial exchange.[312] Although sophisticated risk models try to tame this uncertainty, they cannot eliminate it. When risk models fail, affecting several markets simultaneously, a systemic crisis may ensue. In this situation, policymakers fail, too, because justification of financial regulation is based on the same risk models that failed by overlooking uncertainty to begin with.

Eliminating justification is not an option to cope with this problem. Society benefits from clear guidelines as to what is good conduct of its representatives and likewise, from their accountability based on such guidelines. However, accountability of financial policymakers must be designed in such a way as to ensure that decision-making takes uncertainty into account, although this conduct is more difficult to justify. Failure of policymakers to do so will prevent them from coping with the negative externalities of banking effectively. In other words, when financial regulation ignores uncertainty, the result is financial instability, which, as we have recently experienced, may have dramatic repercussions for the well-being of ordinary people.

Traditionally, banking regulation has sought to prevent banking crises by focusing on the stability of individual banks (micro-prudential regulation).[313] That implies controlling banks' risk-taking both directly, through banking supervision, and indirectly, setting capital requirements against bank assets weighted for their risk. This is a cat-and-mouse game that banking regulation is bound to lose.[314] First of all, risk-taking must be based on conventional models. Banks have incentives to get around the regulatory definition of risk from the moment in which these models are known. Second, banking can be performed by a number of financial institutions other than banks, and those institutions are not subject to the same regulations. Indeed, the

enforcement and citizens when the agent simply follows formulas with a view to justification rather than exercising her best judgment.

[312] See Pacces, The Future, supra note 58.

[313] For an excellent introduction to macroprudential regulation, as opposed to traditional microprudential regulation, see S. G. Hanson, A. K. Kashyap, and J. C. Stein, "A Macroprudential Approach to Financial Regulation", 25 *Journal of Economic Perspectives* 3, 2011.

[314] H. P. Minsky, *Stabilizing an Unstable Economy* (McGraw-Hill Education, 2008), at 279.

institutions can be structured precisely to not have the attributes that would render them subject to the regulations. The sufficient condition is that the institutions' liabilities are accepted as "safe" under a conventional model of risk assessment. AIG and all the other financial institutions engaged in the so-called "shadow banking" are clear examples of how easily this condition can be met.[315]

The pitfalls of the traditional approach, as evidenced by the global financial crisis, have prompted policymakers to look at systemic risk more broadly, for instance by way of macro-prudential regulation.[316] Simply put, macro-prudential regulation tries to identify and contain risk-taking, as well as the externalities stemming from it, from a systemic rather than an individual perspective. That said, both macro and micro prudential regulation suffers from the same problem: Financial regulation cannot be expected to be so dynamic to timely adapt to financial innovation and thus counter regulatory arbitrage. The presence of uncertainty provides high-powered incentives for financial institutions to minimize the regulatory consequences of risk taking, because this strategy will make their banking business (both official and shadow) more profitable. In other words, banking institutions engaging in regulatory arbitrage are simply being entrepreneurial. However, by doing so, they impose a negative externality on the society.

To cope with the negative externalities of banking effectively, policymakers should be entrepreneurial too. This is a rather ambitious goal, if only because policymakers have incentives that structurally differ from those of bankers. These incentives are generally weaker than in the private sector. Because policymakers are motivated more by reputation and prestige than by monetary incentives, the mechanisms of accountability are crucial. Currently, these mechanisms exacerbate the problem because an obvious (and inexpensive) way for policymakers to foster their reputation is to take actions than can readily be justified. These actions are hardly entrepreneurial.[317] On the one hand, they tend to follow the risk models from the private sector, thereby increasing the illusion of safety that these models support. On the other hand, as we have seen in the previous examples, justification prevents policymakers from leaning against the wind, even if they realize that this would serve

[315] See Nabilou and Pacces, "The Law and Economics of Shadow Banking", supra note 19, for a broad discussion of shadow banking and its regulatory implications.

[316] S. Claessens, "An Overview of Macroprudential Policy Tools", 7 *Annual Review of Financial Economics* 397, 2015.

[317] In 1921, Frank Knight noted that: "It is common and natural to assume that a hired manager, dealing with resources which belong to others will be less careful in their use than an owner. The view shows little insight into human nature and does not square with observed facts. The real trouble with bureaucracies is not that they are rash, but the opposite. When not actually rotten with dishonesty and corruption they universally show a tendency to "play safe" and become hopelessly conservative." Knight, supra note 12, at 361.

society better. Leaning against the wind is unlikely to earn policymakers any credit and may even upset some of the constituencies to which they are accountable.

A few commentators have proposed introducing a new set of players, independent from both the private sector and the regulators, to prompt regulators to seriously consider different perspectives. Some economists have suggested introducing an advisory body on financial stability regulation, called "The Sentinel."[318] In a similar vein, some legal scholars have advocated the introduction of "Regulatory Contrarians" in several areas of policymaking, including banking regulation.[319] These proposals address an important part of the problem: regulators tend to become complacent, particularly when they lack input from sources that may show how they are going wrong. Such a feedback is missing especially from financial regulation due to the procyclicality of the debate on financial stability, as hinted before. Regulatory contrarians and similar figures seem to fill in this gap because they would have an explicit mandate to identify potential problems with the existing regulations, which are being overlooked by policymakers because of agency cost, regulatory capture, or mistake.

The challenge for regulatory contrarians is to get policymakers to listen to them.[320] For obvious reasons, in all existing proposals, the contrarians cannot compel the policymakers to act, as otherwise their position would become indistinguishable from that of regulators. Proponents of this approach seem rather optimistic that contrarians would create more awareness among policymakers that they might be missing something in the buildup of systemic risk, which would, in turn, result in timely actions to counter it.[321] If we look at history, however, particularly the latter (timely action) is not a foregone conclusion. The destiny of Cassandras is to remain unheeded until history proves them right, which is usually too late. A few economists and market players did predict the global financial crisis. Nevertheless, regulators did not listen to them.[322] Arguably, giving contrarians institutional stature would give their opinion more weight. However, changing the behavior of financial policymakers may be difficult so long as their accountability regime is unchanged, certainly when memories of the most recent crisis have receded.

---

[318] J. R. Barth, G. Caprio, and R. Levine, *Guardians of Finance: Making Regulators Work for Us* (MIT Press, 2012).

[319] McDonnell and Schwarcz, supra note 18.

[320] See, e.g., Barth, Caprio, and Levine, supra note 318.

[321] See McDonnell and Schwarcz, supra note 18, at 1651.

[322] See, e. g., N. Roubini and S. Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (Penguin Press, 2010), preface; and M. Lewis, *The Big Short* (W. W. Norton, 2010), xviii.

The regime governing the regulation of financial stability need to provide less of an incentive for policymakers to think in terms of justification, or more of a counterweight against such thinking. Policymakers are supposed to exercise judgment as to when and whether to lean against the wind. In the domain of financial stability, these policymakers are normally the central banks, because they have superior information on financial indicators that may hint at the presence of a bubble.[323] Central banks have another advantage: because they have a legal monopoly on money creation, they are the most credible "fire extinguisher" in a crisis. Having to use their monetary powers parsimoniously in a crisis in order to fulfil their mandate and preserve their independence, central banks have both the knowledge and the incentives to act in a timely manner on the factors potentially leading to systemic risk – in other words, they are well positioned as "smoke detectors" as well.[324] The big problem is that, to fulfill this role, central banks need to be able to "take away the punch bowl as the party gets going," which is extremely difficult to do if such action has to be justified. Policing inflation, which central banks typically do, is unpopular as well, but it can be justified by objective indicators. Such indicators do not exist for systemic risk. Policing systemic risk would become impossible for central banks if they had to provide justifications on a regular basis. For example, institutions that are not formally subject to prudential regulation would have reason to challenge, as arbitrary, a central bank's decision to impose capital or liquidity requirements on the grounds of some imprecise measure of systemic risk. After all, a bubble is only conclusively a bubble after it has burst.

Relieving central banks from the need to justify their actions is unthinkable (and undesirable) in a democratic society. However, the presence of regulatory contrarians, as suggested by the recent literature, may be helpful in allowing central banks to be accountable without having to justify their actions on a regular basis.

Here is the solution we recommend. Regulatory contrarians should be asked to provide a non-binding opinion on the proposals by central bankers to introduce preventative macro-prudential regulations, and on the failure to make such proposals. This second opinion is useful because a fundamental problem in assessing the central bank's conduct is that we do not observe the counterfactual world in which they have not acted. This problem becomes slightly less severe if two expert

---

[323] C. A. E. Goodhart, "The Changing Role of Central Banks", BIS Working Paper No. 326, November 2010, available at https://www.bis.org/events/conf100624/goodhartpaper.pdf.

[324] For a non-technical discussion of the role of central banks as "fire extinguishers" and "smoke detectors" of financial crises, see C. A. E. Goodhart "The Macro-Prudential Authority: Powers, Scope and Accountability", 2011 *Financial Market Trends* 1, 2011, available at https://www.oecd.org/finance/financial-markets/48979021.pdf.

decision-makers have independently agreed that a certain policy is warranted to reduce systemic risk. Moreover, the second opinion provides a separate channel for the accountability of central bankers because the contrarian may publicly disagree on either action or inaction.[325] When this is the case, central bankers may still decide to act or not, in accordance with their initial determination. Because the opinion of the contrarian is *not* binding, departing from the contrarian's advice would *not* make central bankers accountable, which in turn implies that central bankers would *not* have to be defensive in their judgment. As in the case of dual-class shares for corporate managers, at first glance this may sound like excessive leeway. However, note that the central bankers—like managers taking commitments to avail themselves of CEMs- would still have incentives to take care in exercising judgment. For instance, time may prove central bankers wrong rather than the contrarian having been right, in which case the central bankers' reputational capital would be depleted. The presence and public resonance of regulatory contrarians allows for an ex-post assessment of the central bankers' conduct, without having to constrain their judgment ex-ante by way of justification.

Having discussed public financial actors, we now offer one final example, involving private financial actors. It involves the role of ratings and rating agencies in the financial crisis. As noted in the introduction, an important factor in the financial crisis was money managers' willingness to treat high rating agency ratings of subprime securities as a near-sufficient condition to their purchase of those securities.[326] Indeed, the extent to which money managers justified their disastrous investments in Enron, and in subprime mortgage securities, by referring to their reliance on ratings by a few well-known rating agencies, Moody's, Standard and Poor's, and Fitch Investor Services, presents a challenge for orthodox economic theory: money managers should expect that they might be getting 'lemons' and either discount accordingly or look at the information they were receiving with a far more critical eye. [327] But money managers seem to have been far more concerned with getting in on 'hot new issuances' of subprime securities than in researching the characteristics of those issuances. Interestingly, and tellingly as to how justification works, the fact that all three agencies had been known to get it grievously wrong as to Enron did not

[325] For a similar approach, albeit based on the reaction to certain predetermined indicators on a comply-or-explain basis, see ibid. at 19.

[326] See Hill, "Justification Norms Under Uncertainty", supra note 49.

[327] See C. A. Hill, "Why Didn't Subprime Investors Demand a (Much Larger) Lemons Premium?", 74 *Law and Contemporary Problems* 47, 2011; D. C. Langevoort, *Selling Hope, Selling Risk: Corporations, Wall Street, and the Dilemmas of Investor Protection* (Oxford University Press, 2016).

stop money managers from characterizing their reliance on the agencies as reasonable when the managers lost disastrously on their subprime investments.

The money managers' best assessment as to how to proceed for their clients would probably not have been to purchase those securities, certainly in the years closest to the crisis: notwithstanding the ratings, there was increasing concern that the ratings might not be accurate, and that we might have been in a bubble that was about to burst. But the money managers' interests were best served by assuring that they would do no worse than their peers, who were also buying the securities. Besides the substantive benefits of being in a herd, there were also considerable benefits of being able to justify what they did by reference to the ratings and to what others were doing.

One of us has articulated a possible solution: an 'unsafe harbor,' wherein courts would require money managers who are being sued to provide evidence that they had done independent inquiry, the aim being to limit a particular strategy associated with justification, herding.[328] Note that one cost of the anticipated need for justification is that the creation of a community which coalesces around norms that are created in part for the ease of coalescence. This dynamic may help explain why the three major rating agencies have managed to hold onto their market shares notwithstanding dramatic misratings as well as significant legislative efforts to get markets to make more use of other agencies. The costs of the three agencies' continuing dominance are well-known: higher priced, lower-quality services, and the ability to move markets in ways that can be quite destructive.[329]

## Conclusion

Corporate governance is largely about the allocation of power between controllers (typically managers but sometimes controlling shareholders) and shareholders. The principal challenge of corporate governance is often, if not typically, understood to

[328] See Hill, "Justification Norms Under Uncertainty", supra note 49; Hill, "Why Didn't Subprime Investors Demand a (Much Larger) Lemons Premium?", supra note 326.

[329] In a similar vein, Pacces and Romano have argued that the problem of non-virtuous competition between the three main rating agencies could be addressed by imposing a limited strict liability for misrating. Because, in that liability regime, rating agencies could choose the degree of liability exposure based on their confidence in their own risk models (i.e. on how much uncertainty such models are exposed to), rating agencies would no longer converge on offering the ratings which are justifiable, but rather compete on the (limited) reliance on their risk model. A. M. Pacces and A. Romano, "A Strict Liability Regime for Rating Agencies", 52 *American Business Law Journal* 673, 2015, https://doi.org/10.1111/ablj.12054.

involve reducing the costs of agents acting for themselves when they should be acting for the corporation and its shareholders. Acting for themselves can include pursuing projects that benefit them more than the corporation, or seeking to hold onto their jobs in the face of hostile acquirers or to continue their control in the face of activist shareholder campaigns, notwithstanding the benefits of such acquisitions or campaigns to the corporation. Such reductions may be achieved through aligning managers' incentives with those of the corporation and its shareholders, and improving how managers are monitored and subject to the discipline of the market, including by allowing those who would unseat or seek to influence management to have more power.

In this story, managers themselves know when they are acting to benefit themselves, and good corporate governance would constrain or prevent them from doing so or punishes them after the fact. Where they are pursuing their self-interest and not the corporation's, or where their ideas are not the best ones, others with what they think are better ideas are free to pursue those ideas if they can finance them, and the market sorts everything out. This is largely the story of what might be called the pro-activist-shareholder camp, where traditional agency costs of this sort loom large.

The opposing camp thinks that 'others' are all too often people who have figured out how to benefit themselves at the expense of the corporation and its (other) shareholders, and that relatively speaking, traditional agency costs are much less of a peril, such that managers should be helped to defeat acquirers and activist shareholders when they wish to do so.

This article describes a neglected agency cost: the incentive for those believing themselves to be accountable to others to act more to justify themselves than because they think that the course of action they are choosing is best for their principal. And it is not just an agency cost. There are social costs as well, such as the costs of foregone research and development. Moreover, those engaging in justificatory decision-making are not just agents, or doing so to justify themselves to their principals. Those motivated to use more readily justifiable strategies include people answering to others who are not their principals, such as financiers, the broader community, and lawmakers.

The more uncertainty there is, the more what is justifiable may diverge from an actor's assessment of the best way to proceed were justification not so much at issue. Having identified these costs, we then argued for a solution—a better combination of managerial discretion and accountability than presently exists, that managers and shareholders could agree upon, whether in an IPO – as is already the case in many jurisdictions - or when a company is already public. With greater recognition of the problem and its costs, more attention can be paid to minimizing it—something that should benefit corporations, as well as the broader society.

# about ECGI

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

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

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

**Electronic Access to the Working Paper Series**

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

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