Hedge-Fund Activism: Principal Costs, Agency Costs, and Governance Structures

Zohar Goshen and Richard Squire

Abstract

Whose side should lawmakers take in control contests between corporate shareholders and directors? Most who debate this question attempt to resolve it empirically: If empowering shareholders produces “short-termism” (the pursuit of immediate profits at the expense of long-term corporate value), lawmakers should side with directors; if agency costs are the greater hazard, they should side with shareholders. Unfortunately, empirical studies on both sides of the debate are inconclusive. In this Article, we offer a new framework to resolve the legal question of allocation of power between directors and shareholders. Any given for-profit-firm is part of a menu of governance structures (i.e., different allocations of control rights within ownership structures) offering different combinations of agency costs and principal costs: the costs that, when investors rather than managers exercise control, the investors impose upon themselves due to lack of information, collective-action problems, and other limitations. The desire to avoid principal costs is the reason that investors share control with managers in the first place. The tradeoff between principal costs and agency costs is inescapable, and the balance between the two is a firm-specific choice reflected in the firm’s choice of governance structure. Lawmakers should respect this choice as a core element of any governance structure. An implication is that Delaware judges and the SEC should not completely insulate boards of widely-held corporations from both hostile raiders and activist hedge funds. As complete managerial insulation is provided by a the dual-class share structure, the dispersed-ownership structure should not be de facto transformed into a dual-class. While a minority of US firms do choose to grant management incontestable control through dual-class shares, the majority of US firms opt instead for a different governance structure that allows directors to exercise authority but empowers shareholders, through control contests, to hold directors accountable.

I. Introduction

A central question in corporate law is whether lawmakers should side with directors or shareholders in battles for corporate control.¹ Should shareholders be

¹ Compare Leo E. Strine, Jr., Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law, 114 COLUM. L. REV. 449 (2014) [hereinafter: Can We
empowered to control the management of the corporation, or should directors be free to pursue their business visions without shareholder interference? This debate has intensified with the rise of activist hedge funds that target publicly traded corporations. The debate’s contestants attempt to resolve the legal questions raised by activist hedge funds by studying whether activism tends to increase or decrease long-term returns to shareholders. Thus, the debate over activism has morphed into an argument over whether activists engage in “short-termism.” While activism’s proponents point to alleged improved corporate governance and reduced managerial agency costs, opponents cite activists’ short-term investment horizons, which they allege distort corporate strategy. The debate has now reached its empirical stage, with both sides invoking studies that appear to support their respective positions but, unfortunately, the results are inconclusive.

In this Article, we offer a new framework for analyzing the legal questions that activism raises. Our framework is based on the unique division of control rights between shareholders and directors reflected in the dispersed-ownership structure. A firm can be

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2 Hedge funds are investment vehicles in which normally only accredited investors invest. An activist hedge-fund normally buys a 10% block of shares and then solicits the support of other institutional investors to pressure management to make some corporate changes relating to corporate governance, business strategy, or board and management composition. Brian Cheffins & John Armour, The Past, Present and Future of Shareholder Activism by Hedge Funds, 37 Iowa. J. Corp. L. 51 (2011). See infra Part II (outlining debate over value of hedge fund activism).
3 See, e.g., Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. PA. L. REV. 1021, 1085 (2007) (arguing the empirical evidence on the extent and magnitude of market myopia is “sketchy at best,” and the existence and severity of the “short-termism problem” is the least proven of the problems posed by hedge fund activism); Mark J. Roe, Corporate Short-Termism—In the Boardroom and in the Courtroom, 68 BUS. LAW. 977, 1005 (2013) (“Overall, the evidence that financial markets are excessively short-term is widely believed but not proven, and there is much evidence pointing in the other direction.”); Lucian Bebchuk, The Case for Increasing Shareholder Power, 118 HARV. L. REV. 833 (2005) [hereinafter: The Case].
viewed metaphorically as a “contract,” a “nexus of contracts,” an “organization,” an “enterprise,” an “institution,” a “corporate constitution,” a “governance-template,” or an “ownership-structure.” The proliferation of terms indicates the difficulty in treating the governance structure of a publicly traded firm as a pure “contract” as traditionally understood by contract law. A firm is only metaphorically a contract because the corporate contract is incomplete in nature, many firms are decades old and the intention of their founders are unknown, many unexpected changes in the economic and business environment have taken place, many unexpected legal changes and innovations have happened, many financial innovations were also unexpected, and the identities of the parties to the contract (the directors and shareholders) are constantly changing. To capture the core difference between ownership-structures, i.e., the different allocations of control rights between investors and managers, we choose the term “governance structure.”

A governance structure constitutes an agreement among those who affiliate voluntarily with the firm over how much control to delegate to directors, and how much to reserve for shareholders. When establishing a firm, parties can choose from a range of governance structures that offer different divisions of control between the equity investors and the managers. Therefore, when evaluating legal challenges presented by activist hedge funds, or indeed any claim regarding a contest of control between corporate shareholders and directors, a judge’s primary task is to enforce the balance of power established in any given governance structure.

Any governance structure divides power between investors and managers, reflecting a balance between two types of costs. The first type, agency costs, is the focus

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10 See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 1 (“A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty.”).
of most corporate-law scholarship.\textsuperscript{11} Thus, scholars have observed how managers can abuse their positions to advance their private interests at the expense of shareholders, or can simply be lazy or incompetent.\textsuperscript{12} The second type of costs, which we label \textit{principal costs}, has received much less attention from scholars.\textsuperscript{13} But principal costs are, we argue, equally important, because they are the counterweight to agency costs in any governance structure. The division of power between shareholders and directors in a corporation reflects a balance of these costs for a particular enterprise.

Principal costs can arise whenever shareholders exercise that measure of control that the governance structure reserves for them. In particular, they occur whenever shareholders act in ways that—most often, but not always, unintentionally—reduce the value of the corporation’s equity. Why would shareholders ever take actions that harm their collective interests? The simplest answer is that they may lack the information or expertise needed to make the best decision. In addition, shareholder decisions can generate principal costs because the shareholders often have conflicts of interest among themselves,\textsuperscript{14} and they may face high coordination costs and collective-action problems.\textsuperscript{15} It is the desire to avoid principal costs that prompts shareholders to delegate authority to the board of directors in the first place. And yet, because of agency costs, complete delegation is rarely wise: the shareholders will usually want to retain some power to hold the board accountable. But the same considerations that prompt shareholders to delegate authority will also cause them to incur principal costs when they try to hold the directors accountable for exercising authority.

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\textsuperscript{11} See, e.g., John Armour et al., \textit{What is Corporate Law, in THE ANATOMY OF CORPORATE LAW} 1, 2 (Reinier Kraakman et al., eds., 2d ed. 2009) (“Much of corporate law can usefully be understood as responding to three principal sources of opportunism: conflicts between managers and shareholders, conflicts among shareholders, and conflicts between shareholders and the corporation’s other constituencies. . . .”).
\textsuperscript{12} See Jensen & Meckling, \textit{supra} note 7 (developing the formal analysis of agency costs).
\textsuperscript{13} We thank Anna Shifflet, our research assistant, for suggesting the term.
\end{footnotesize}
To be sure, previous scholarship had identified particular types of principal costs, such as short-termism and the shareholder collective-action problem.\textsuperscript{16} Our contributions are to recognize that these costs constitute a general category on par with agency costs, and that each governance structure reflects a firm-specific tradeoff between the two.\textsuperscript{17} We argue that, when dividing control between investors and managers in a governance structure, it is impossible to reduce one type of cost without increasing the other. Any governance structure reflects a division of control that, based on firm-specific factors such as the industry and the identity of the key players, aims at minimizing the sum of principal costs and agency costs. Based on this observation, we show that different governance structures lie along a spectrum, offering different cost tradeoffs. At one extreme is the dual-class share structure, a type of corporation in which the directors have complete, incontestable control.\textsuperscript{18} Under that structure, principal costs are very low but exposure to agency costs is very high. At the opposite extreme—rarely seen except in small sole proprietorships and partnerships—are firms in which the equity investors retain all control for themselves, thereby avoiding agency costs but generating principal costs.\textsuperscript{19} Toward the middle of the spectrum is the public corporation with dispersed-ownership.\textsuperscript{20} To the extent that entities such as hostile raiders and activist hedge funds are allowed to assemble share blocks, they can contest control of such corporations, thereby generating principal costs but potentially keeping agency costs in checks.


\textsuperscript{17} Looking at the question from a different angle, Professor Henry Hansmann has analysed the choice of enterprise form (employee-owned, shareholder-owned, co-operative, non-for-profit, etc.) as a decision aimed at minimizing the sum of “contracting costs” (for all patrons of the enterprise) and “ownership costs” (which combine agency costs and what we call “principal costs”). Henry Hansmann, \textit{Ownership of the Firm}, 4 JLEO 267 (1988). Our analysis considers only for-profit enterprises, and we presuppose that equity investors are the owners. We then analyse the variety of ownership structures based on the goal of minimizing the sum of agency costs and principal costs.

\textsuperscript{18} See infra Part III.d.i.

\textsuperscript{19} See infra Part III.a (explaining that principal cost risk is motive for delegation).

\textsuperscript{20} See infra Part IV (describing the principal/agency cost tradeoff of widely-held firms).
This framework implies that there is no particular governance structure that can be described as intrinsically good, bad, welfare-enhancing, or inefficient. A structure that is right for one type of business may be ill-suited for another. Those who affiliate voluntarily with a corporation—including shareholders and managers—are on notice of the governance structure established by the firm. They therefore should be expected to adjust the compensation they demand, or the price they are willing to pay, accordingly. A court should not allow parties to insist that, even though they have voluntarily affiliated with a particular governance structure, the court should provide them with the tradeoff between principal costs and agency costs afforded by a different structure.

Most importantly, any governance structure also reflects how much enforcement discretion is afforded courts during the life of the firm. A corporation is a governance structure that subjects directors to judge-defined fiduciary duties that, unlike in an LLC, cannot be eliminated in the firm’s constitutional documents. That is, the corporate governance structure delegates to judges the role of interpreting the corporate governance structure and also enlists their assistance in writing it. Why would parties to any governance structure give judges such a high degree of latitude? We believe that the choice of the corporate form reflects recognition that, because corporations have indefinitely long lives, circumstances will change in unforeseeable ways. The industry in which the firm operates will probably change, as will the identity of its key players and the broader legal and economic environment. Investors and managers therefore may want the assistance of judges, and perhaps lawmakers more generally, in updating their governance structure in response to these changed circumstances. The challenge for judges is to define the realm in which they have discretion to update or “fill in the gaps” in the governance structure.21 We argue that, while judges have some latitude, each governance structure’s basic division of control between managers and investors establishes a border that judges must not cross.

In this analysis, the tradeoff between principal costs and agency costs can be seen as creating a “tradeoff boundary” along which reductions in one type of cost always

require increases in the other. Changing circumstances can cause a governance structure to drift off the tradeoff boundary: when that happens, judges should update fiduciary duties to return the firm to the boundary. Judges should not, however, issue rulings that transform one basic governance structure to another.

Our framework has multiple implications for corporate law and policy. Consider the controversy over whether Delaware courts should allow boards of dispersed-ownership corporations to use low-threshold poison pills and similar devices to thwart activists. Our framework suggests that the answer is no. Two accountability mechanisms have been developed to contest control of dispersed-ownership corporations: hostile tender offers and shareholder activism. To give meaning to a firm’s choice of the dispersed-ownership structure, courts must give shareholders access to at least one mechanism for holding directors accountable. Blocking both hostile raiders and activist hedge funds would effectively nullify the corporate governance structure, transforming dispersed-ownership corporations into de facto dual-class corporations, in which managers enjoy complete insulation. Therefore, so long as Delaware courts maintain the “substantive coercion” doctrine, which enables boards to thwart hostile tender offers, they must not also uphold measures that block activist hedge funds. As a matter of accepting the choice of a governance structure, courts must leave the door open for at least one of these types of “accountability specialists,” even if the courts believe that both raiders and activists generate short-termism that harms shareholders (and perhaps the

22 We borrow the term from finance theory, see, e.g., Robert C. Merton, An Analytic Derivation of the Efficient Portfolio Frontier, 7 J. FIN. & QUANT. ANALYSIS 1851 (1972).
23 A poison pill is a “shareholder rights plan” which the board includes in the corporate bylaw. According to the plan if a person purchased shares in excess of a predetermined threshold (say 20%) without the board’s approval the rights are triggered. The corporation will then exclude the person making the unauthorized purchase of the shares, and will offer to all other shareholders the right to either buy large amount of newly issued shares at substantial discount or to sell back some of their shares to the corporation at a high premium. Either way, the economic value of the non-participating person will be substantially diluted. The pill thus effectively forces would-be takeover bidders to negotiate directly with the board, or to run a proxy-fight to replace the board with new directors that will approve the takeover. See Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985) (approving the use of a poison pill). A low threshold poison pill sets the trigger for diluting a non-authorized buyer at 10% or lower, in order to limit the hedge fund’s ability to buy more shares, thereby reducing the likelihood of a hedge fund winning a proxy contest. For a complete analysis see infra Part V.a.i.
24 See infra Part IV.a.i-ii.
economy in general). Parties who affiliate voluntarily with a particular governance structure are entitled to have its basic terms enforced.

Another implication of our framework concerns federal lawmakers. Corporate directors and their advocates are currently lobbying the Securities Exchange Commission (SEC) to give activist investors only one day, instead of ten, to disclose publicly an acquisition of five or more percent of a public company’s shares. This lobbying effort aims to insulate boards by shrinking the share blocks that activist funds can assemble before they must reveal information that causes the target’s share price to spike. Since an activist fund’s profits increase with the number of shares it can acquire pre-spike, shortening the disclosure window would deter activism. In concert with Delaware’s “substantive coercion” doctrine, such a change would wrap boards in two layers of insulation: one provided by state law, the other by federal law. Such a result would run contrary to the dispersed-ownership governance structure. The SEC therefore should reject this proposed change, at least until Delaware reconsiders “substantive coercion.”

We begin our discussion by establishing the contemporary policy context for our analysis. That context is the debate over short-termism that first raged during the heyday of hostile raiders and that the rise of activist hedge funds has rekindled. We then present our theory of governance structures, emphasizing the importance of principal costs—of which shareholder short-termism is only one example. Next, we lay out the various firm governance structures along a spectrum defined by the principal-cost/agency-cost tradeoff boundary. We pay particular attention to the dispersed-ownership structure, and we describe why relative levels of principal costs and agency costs under that structure depend on whether hostile raiders or activist hedge funds are the main initiators of control contests. Finally, we discuss implications of our thesis for Delaware courts and the SEC.

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27 See infra Part V.a.ii.
II. The Short-Termism Debate

In corporate law, “short-termism” refers to management decisions that pursue immediate profits but reduce the firm’s long-term value. Attorney Martin Lipton and Professor Lucian Bebchuk represent the opposite poles of the shareholder activism debate. Lipton argues that investor short-termism is a large hazard and that, to reduce it, lawmakers should allow boards of directors to insulate themselves from shareholder interference. Bebchuk counters that the short-termism hazard is exaggerated and that lawmakers can best foster economic growth by empowering shareholders to hold directors accountable. The two sides’ assessments of the size of the short-termism hazard determine their positions in the current debate over whether lawmakers should assist corporate boards in control contests with activist hedge funds.

The general incorporation statutes of the various states give a corporation’s board the exclusive power to manage the corporation (subject to any exceptions specified in the corporation’s charter). Shareholders, in turn, have the power to elect directors and to veto important business decisions such as mergers; they also are generally free to sell their shares. Shareholders’ power to vote directors out of office, or to sell them to a hostile raider who will do the same, can frustrate a board’s pursuit of its long-term business vision. Those who side with Lipton argue that directors who are at risk of being displaced at any time by myopic shareholders will defensively avoid long-term investments and instead focus on short-term share performance. In this way, it is argued, exposure to market pressures can discourage corporate executives from making the investments necessary for economic growth. Thus, lawmakers should foster long-term investment

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28 See, e.g., Dean Krehmeyer, Matthew Orsagh & Kurt N. Schacht, CFA Center for Fin. Integrity & Bus. Roundtable Inst. for Corporate Ethics, BREAKING THE SHORT-TERM CYCLE: DISCUSSION AND RECOMMENDATIONS ON HOW CORPORATE LEADERS, ASSET MANAGERS, INVESTORS AND ANALYSTS CAN REFOCUS ON LONG-TERM VALUE 3 (2006) (defining short-termism as “the excessive focus of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to the strategy, fundamentals, and conventional approaches to long-term value creation”).


30 See, e.g., Strine, One Fundamental Question, supra note 4; Bratton & Wachter, supra note 4.
by insulating directors from shareholder interference.\textsuperscript{31} But, Bebchuk’s side observes, board insulation has a downside: if shareholders cannot hold boards accountable, then directors might place their personal interests ahead of shareholder interests. \textsuperscript{32} Shareholders will be unable, in other words, to curb agency costs. This is the essence of the short-termism debate: the question whether short-termism or agency cost is more important. The debate was born in the 1980s, when hostile takeovers were at their peak, and it has made a comeback with the rise of shareholder activism.\textsuperscript{33}

How exactly can a firm’s managers deliver short-term profits at the expense of long-term value? There are two general theories of how short-termism works: we refer to them here as \textit{myopic markets} and \textit{hidden value}.

\textit{Myopic markets}: The “classic” theory of short-termism asserts that stock markets often suffer from myopia. In particular, markets place too little value on the profits that long-term investments generate. Such myopia might occur because stock-market investors systematically underestimate the likelihood that long-term business projects will succeed, or markets might overestimating the volatility of the returns from such projects, and thus apply too high a risk premium when calculating their present value. Alternatively, markets can be myopic in rational markets when there are heterogeneous expectations and constraints on short sales,\textsuperscript{34} or when potential arbitrageurs lack enough capital to wait for mispricing to correct.\textsuperscript{35} In either case, markets will consistently underprice the shares of firms that will generate most of their profits later rather than sooner.

\begin{itemize}
\item \textsuperscript{31} See Jacobs, supra note 19 (arguing that boards need insulation from shareholders to plan for the long-term); Martin Lipton, \textit{Twenty-Five Years After Takeover Bids in the Target’s Boardroom: Old Battles, New Attacks and the Continuing War}, 60 BUS. LAW. 1369 (2005); Martin Lipton & Jay W. Lorsch, \textit{A Modest Proposal for Improved Corporate Governance}, 48 BUS. LAW. 59 (1993); Martin Lipton & Steven A. Rosenblum, \textit{A New System of Corporate Governance: The Quinquennial Election of Directors}, 58 U. CHI. L. REV. 187 (1991) (arguing for board autonomy from market influence via five-year board terms).
\item \textsuperscript{32} See Bebchuk, \textit{The Case}, supra note 3.
\item \textsuperscript{33} See Martin Lipton, \textit{Takeover Bids in the Target’s Boardroom}, 35 BUS. LAW. 101, 104–105 (1979) (arguing that securing long-term economic interests requires guaranteeing the ability of companies to “defend against takeovers that would adversely affect long-term planning”).
\item \textsuperscript{34} Edward Miller, \textit{Risk, uncertainty and divergence of opinion}, 32 J. Fin. 1151 (1977).
\item \textsuperscript{35} Andrei Shleifer & Robert W. Vishny, \textit{The Limits of Arbitrage}, 52 J. Fin. 35 (1997).
\end{itemize}
Because of such myopia, an activist hedge fund could force a corporation to take actions that temporarily drive up, but ultimately depress, the stock price.\textsuperscript{36} Such actions will benefit the activist fund because it owns a corporation’s stock for only a short period.\textsuperscript{37} These actions generally involve a reduction in the corporation’s ability to make long-term investments. For example, the corporation might cut investment directly, such as by curtailing research and development. Or it might take on debt that enables it to make a one-time dividend payment or share repurchase but that hampers its capacity to reinvest earnings in long-term projects. Finally, the corporation might raise cash by selling off assets that have long-term growth potential. Such actions allegedly drive up the share price in the short run but reduce the corporation’s value.

This myopic-markets theory of short-termism assumes inefficient markets.\textsuperscript{38} If markets valued long-term investments accurately, actions that harmed a corporation in the long term would immediately reduce its stock price, even if the actions increased reported profits in the current period. Critics of the myopic-markets theory doubt that markets systemically under-price long-term investments or can easily be fooled by such “tricks.” Proponents of board insulation find support both in theoretical models showing that market myopia is possible,\textsuperscript{39} and in empirical evidence that either challenges the


\textsuperscript{37} Typically less than a year passes from hedge fund investment to exit. See Alon Brav, Wei Jiang & Hyunseob Kim, Hedge Fund Activism: A Review, Foundations and Trends in Finance (available at http://ssrn.com/abstract=1551953) at 18, T.4.2 (Feb. 2010) (identifying 266 day period between Schedule 13D filing and divestment); Alon Brav, Wei Jiang, Frank Partnoy & Randall S. Thomas, Hedge Fund Activism, Corporate Governance and Firm Performance, 63 J. Fin. 1729, 1769 (2008) (identifying 369 days for the same period, and 319 as the median duration in the case of hostile transactions) [hereinafter Firm Performance].

\textsuperscript{38} “For the short-term trading horizon of hedge funds to generate a short-term investment outlook for hedge fund managers, the stock market must suffer from myopia: that is, it must undervalue long-term investments relative to short-term investments. If the market does not itself suffer from such a bias, then the interests of investors with short-term trading horizons will not conflict with those of investors with long-term trading horizons.” Kahan & Rock, supra note 3 at 1084.

\textsuperscript{39} See, e Jeremy C. Stein, Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior, 104 Q. J. ECON. 655, 655–56 (1989) (a game theory model according to which if markets infer positive values from certain observable managerial signals, and manipulation of those signals is not easily detected, managers have an incentive to manipulate these signals to enhance stock prices); Adam
efficiency of markets or correlates the adoption of short-term strategies with shareholder pressure. Of course, the other side to the debate finds support in empirical studies showing that markets are efficient and that shareholder activism improves corporate value in the long run.

Hidden value: The second main theory of short-termism argues that markets simply lack full information. Since market prices—even when the market is efficient—only reflect public information, the market will underprice the stock of a corporation whose board cannot disclose favorable inside information. A control contest that occurs during this period of undervaluation might cause shareholders to lose the corporation’s

Brandenburger & Ben Polak, When Managers Cover Their Posters: Making the Decisions the Market Wants to See, 27 RAND J. ECON. 523, 526–27 (1996) (explaining myopia as a function of information asymmetries between managers and shareholders); Simon Grant et al., Information Externalities, Share-Price Based Incentives and Managerial Behavior, 10 J. ECON. SURVEYS 1 (1996); Natalie Mizik, The Theory and Practice of Myopic Management, 47 J. MARKETING RES. 594, 596 (2010); Andrei Shleifer & Robert W. Vishny, Equilibrium Short Horizons of Investors and Firms, 80 AMER. ECON. REV. 148 (1990) (explaining that it is less risky and less costly for asset managers to arbitrage a short-term asset for which mispricing will disappear in the short term than a long-term asset where there is more time for bad news or a wave of pessimism to hit).

See, e.g., Daniel Ferreira, David Kershaw, Tom Kirchmaier, and Edmund Schuster, Shareholder Empowerment and Bank Bailouts (2013) (showing that banks in which managers were more insulated from shareholders were roughly 18 to 26 percentage points less likely to be bailed out during the financial crisis); Strine, Can We Do Better, supra note 1, 463 n.41 (citing empirical studies suggesting that direct shareholder democracy might harm long-term corporate value); Brian J. Bushee, Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value?, 18 CONT. ACCT. RES. 207 (2001) (finding high levels of transient ownership are associated with an over-weighting of near-term expected earnings); Brian J. Bushee, The Influence of Institutional Investors on Myopic Investment Behavior, 73 ACCT. REV. 305 (1998) (arguing that high level of institutional ownership by institutions exhibiting high portfolio turnover, diversification, and momentum trading, significantly increases managerial incentives to pursue short-term projects); Tomislav Ladika & Zacharias Sautner, The Effect of Managerial Short-Termism on Corporate Investment (Feb. 2014) (finding that management with shortened timeframes for performance based compensation resulted in less real investment by corporations); Kevin J. Laherty, Economic "Short-Termism": The Debate, the Unresolved Issues, and the Implications for Management Practice and Research, 21 ACAD. MGMT. REV. 825, 832 (discussing short-termism as managerial opportunism).

“hidden value,” either because the shareholders tender their shares to a raider at too low a price,\textsuperscript{43} or they lend their support to a different business strategy proposed by an activist hedge fund in a proxy fight.\textsuperscript{44} Of course, the two theories are not mutually exclusive: markets could be myopic and they also could under-price firms with hidden value.

The empirical battle over short-termism has not yet produced a clear winner.\textsuperscript{45} We will argue in this Article, however, that the legal question whether boards should be allowed to resist shareholder activism can be answered as a matter of interpretation of the governance structure underlying the corporation with dispersed ownership.

III. The Tradeoff between Principal Costs and Agency Costs

In this part we offer a new framework for understanding the debate over hostile raiders, shareholder activism, and more generally the proper division of control between corporate directors and shareholders. We argue that this division of control is one of the

\textsuperscript{43} This version of short-termism, called the “hidden value” theory, was analysed by Black and Kraakman in the context of the debate over hostile takeovers. They specified nine required assumptions for the hidden value claim to be valid: (1) the quality of the board’s private information is very good; (2) the board’s ability to communicate its private information to shareholders and potential acquirers is poor; (3) the magnitude of the board’s private information is large; (4) hidden value can remain hidden for long periods of time; (5) most target boards are trustworthy, more so than shareholders believe; (6) an investment banker’s opinion is a credible check on the target board’s claim of hidden value; (7) hidden value often cannot be captured in the takeover market; (8) long-term shareholders and short-term shareholders have different interests, and long-term shareholder interests should control; and (9) the interests of undiversified investors count more than those of diversified investors. Black and Kraakman doubted that the required conditions are all likely to be true. “Under elementary principles of finance, even short-term investors have an incentive to maximize the firm’s long-term value, because only by doing so can they maximize the price at which long-term investors will buy the shares that short-term investors will soon want to sell (the unity of long and short-term shareholder interests is known as Fisher separation).” Bernard Black & Reiner Kraakman, Delaware’s Takeover Law: The Uncertain Search for Hidden Value, 96 NW. U. L. REV. 521, 529-33 (2002).

\textsuperscript{44} In the context of activist hedge funds rather than hostile raiders, short-termism due to asymmetric information might be a more plausible claim, for three reasons. First, while boards legally can communicate inside information to a raider who purchased control, the same is not true when the party contesting control is an activist hedge fund, who will never acquire a control block. Thus, when management cannot disclose inside information to public shareholders without destroying corporate value, it also will be unable to make selective disclosures to activist hedge funds. Second, as activist hedge funds do not pay control premiums to target shareholders, the magnitude of management inside information and its quality do not have to be high to make activism profitable. Third, activist funds might be able to complete their control contests more quickly than a hostile raider can, which means that activism may be more likely to happen during a period when the board is unable to reveal the corporation’s “hidden value.”

\textsuperscript{45} Coffee & Palia, supra note 5.
core elements of the corporate governance structure, binding on all who affiliate voluntarily with the firm. Just as courts are not free to disregard core terms such as limited shareholder liability and free transferability of shares, they are not free to upset the balance of power between shareholders and managers that is embodied in a corporate governance structure. Instead, shareholders and managers must take notice of all of their corporation’s core terms and adjust accordingly.

The division of control reflected in the corporate governance structure deserves judicial respect because it reflects a firm-specific judgment over how to strike a balance between two opposing types of costs. One type—agency costs—is well-known among scholars. Agency costs arise whenever shareholders delegate authority to managers. The second type—principal costs—arises to the extent that the corporate governance structure, instead of delegating control to directors, leaves it in the hands of shareholders. Although principal costs have attracted far less scholarly attention, they are just as important as a matter of theory and practice, as they are the factor against which any governance structure weigh agency costs when deciding how much control to delegate to directors, and how much to reserve for shareholders. The choice of balance drives the selection of governance structure, determining whether, for example, to adopt a dual-class share structure, or instead opt for dispersed-ownership. Using this framework, we can place the various possible governance structures along a spectrum, based on the tradeoff between principal costs and agency costs that each offers.

a. Principal Costs and Agency Costs

Shareholders incur principal costs whenever they exercise authority in a manner that—in most cases unintentionally—reduces the value of their equity stakes in the corporation. The two types of short-termism we discussed in Part II are sources of principal costs in publicly traded corporations. But principal costs can arise in all firms, including sole proprietorships, and it is the desire to avoid them that causes principals to delegate authority to agents. To see principal costs in their simplest form, recall the

46 See Jensen and Meckling, supra note 7.
47 See, e.g., the articles cited supra note 16.
storied case of Meinhard v. Salmon,\(^{48}\) involving a joint venture to develop a plot of real estate in midtown Manhattan. Meinhard provided all of the capital, but he lacked the right knowledge to run the business. He was, in Judge Cardozo’s (even in 1928) hoary phrase, a “woolen merchant,” not a real-estate developer.\(^ {49}\) Had he decided to run the business himself, he would undoubtedly have made many expensive mistakes, or in other words, incurred principal costs. So he delegated authority to manage the venture to Salmon, who had the relevant expertise. Legal scholars invariably cite differences in expertise as a primary reason that shareholders delegate authority to corporate boards.\(^ {50}\) The partnership of Meinhard and Salmon shows that lack of expertise is a type of principal cost that can arise in even the simplest firm. To reduce that type of principal cost, an investor delegates authority to an agent who knows more about how to run the business than the principal does.

A different type of principal cost arises when a principal, regardless of whether she has the knowledge to run the business, is unwilling or unable to provide all of the capital. The principal may then have to bring in other equity investors.\(^ {51}\) To the extent that these other investors share control, a host of conflicts can arise. The investors may have different investment horizons, different needs for cash payouts, or differences of opinion about how to run the business. They may also have outside interests that compete with their interests in their joint enterprise.\(^ {52}\) A further problem is that the principals may find it difficult to coordinate their efforts. Finally, they may face a collective-action problem: some principals might shirk the hard work of running the business, hoping to take a free ride on the efforts of the others. All of these problems are sources of principal costs. To obviate them, the investors might decide to delegate authority to a common agent, entrusted with operating the business on the principals’ behalf.\(^ {53}\)

\(^{48}\) 164 N.E. 545 (N.Y. 1928).
\(^{49}\) Id. at 547.
\(^{50}\) Stephen M. Bainbridge, Director Primacy in Corporate Takeovers: Preliminary Reflections, 55 STAN. L. REV. 791, 792 (2002).
\(^{51}\) Alternatively, the principal might raise funds by borrowing. Our analysis will still apply.
\(^{52}\) See e.g., Bainbridge, supra note 50, at 14.
As, however, observers have been noting since antiquity, delegating authority to an agent is rarely costless. Agents can prove to be incompetent or inefficient, they can abuse their authority, and they can simply be overconfident in their judgment. Formally, we can divide agency costs into two categories. Agents can engage in mismanagement, such as by shirking, empire-building (expanding a business in ways that give themselves more power but do not make the principals richer), or spending resources in ways to hide the business’s performance from the principals. And agents can also engage in takings: they can divert wealth to themselves by, for example, consuming excessive pay and perks, or engaging in self-dealing on terms that are unfavorable to the principal.

To reduce agency costs, principals can circumscribe an agent’s authority. They can limit the scope of delegation as an initial matter, by, for example, requiring that the agent obtain the principals’ consent before engaging in important transactions (such as selling the business). Or they can give the agent broad authority but then hold the agent accountable, such as by retaining the power to fire the agent for poor performance. But regardless of whether principals limit an agent’s authority ex ante or hold the agent accountable ex post, they are effectively retaining some control for themselves, and thus will incur principal costs. In this way, those who form a business confront an unavoidable

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54 See, e.g., Luke 12:45 (“But suppose the servant says to himself, ‘My master is taking a long time in coming,’ and he then begins to beat the menservants and womenservants and to eat and drink and get drunk.”)


tradeoff: Although they can try to minimize the sum of principal costs and agency costs by choosing an appropriate governance structure, they cannot alter the division of control in a way that reduces one type of cost without increasing the other.

b. Delegation and Accountability in the Corporation

In addition to the other choices they confront in forming a firm, the parties to a corporate governance structure must decide on how to divide control between the shareholders (the principals) and the directors (the agents). The division they choose is one of the core terms of the corporate governance structure. In a closely-held corporation, shareholders can afford to retain most of the control. But when the corporation is widely held, shareholders have no choice but to delegate a large amount of authority to directors. Thus, in a small or closely-held enterprise, the principals can retain control over the “big picture”: the business vision and the plan for achieving it. Agents can be restricted to the task of implementing that plan. In a widely held corporation, by contrast, shareholders must turn over responsibility for even the big picture to the board of directors and the officers it hires.

To see why such delegation is necessary, imagine a widely-held public corporation called Direct Democracy Company. Per its charter, any of its constantly changing thousands of shareholders may, at any time, post a proposed change in its business vision on its public website. Once a proposal appears, a simple majority of the shareholders can ratify it by online voting. The corporation has managers, but their only job is to implement business plans that the shareholders have ratified. How likely is it that Direct Democracy Company will turn a profit? As a widely-held entity, its shareholders will naturally have dispersed views, conflicts of interests, and different investment horizons and goals. They also will face collective-action and coordination problems because each owns only a small fraction of the corporation, which each shareholder views in the context of a diversified portfolio. And the shareholders will not be privy to

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60 Individual investors, many of whom hold a small fraction of a wide variety of companies, will exhibit rational apathy about management’s decisions. While the rise of the institutional investor, which holds a larger position in many companies and is devoted to overseeing its investments, might suggest a decline in this apathy, in fact these institutional investors still appear reticent to interfere with management. See Ronald J. Gilson & Jeffrey T. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the*
much of the relevant information possessed by the firm’s managers, as posting all inside information on the company’s website would compromise the firm’s competitive position. Under such conditions, we can have little doubt that the most basic sources of principal costs—lack of knowledge, conflicting interests, and collective action problems—would quickly consume all of the firm’s capital, consigning it to an early bankruptcy.

By comparison with dispersed shareholders, a board of directors can be both well-informed and consistent in its views and objectives. It is thus rational for shareholders of a public corporation to entrust the board not only with implementing the business vision, but also with developing that vision in the first place. Such a high degree of delegation does not mean that the shareholders cannot simultaneously try to reduce agency costs. Shareholders can take certain actions aimed to reduce agency costs, for example, aligning directors’ financial interests with their own by tying management pay to share performance or requiring directors to hold large equity stakes, or limiting the scope of the board’s authority by requiring shareholder approval of major decisions. Additionally, shareholders can employ accountability mechanisms, such as exercising the shareholder franchise, the power of shareholders to vote directors out of office. But, again, there is no such thing as a free lunch. The more that shareholders try to reduce agency costs through ex ante authority limits and ex post accountability mechanisms, the more that they expose themselves to principal costs. The same factors that lead shareholders to delegate authority—lack of expertise, conflicts of interest, and collective

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*Revaluation of Governance Rights*, 113 Colum. L. Rev. 863, 889—95 (2013). Gilson and Gordon explain how institutional investors such as mutual funds and public funds undervalue their voting rights because of a divergence between their interest in relative firm performance and shareholders’ interest in absolute performance. See also Kahan & Rock, supra note 3 at 1057–62 (citing low pay and incentives, political constraints, and conflicts of interest as factors that keep public funds from pursuing aggressive activist strategies).

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61 Bainbridge, supra note 47, at

62 See, Jensen & Meckling, supra note 9 (Management’ incentives to mismanage decreases as managers have more equity in the corporation); Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. Fin. 831, 864 (1993) (arguing that encouraging directors to hold substantial equity interests would provide better oversight incentives); Michael C. Jensen & Kevin J. Murphy, *CEO Incentives: It’s Not How Much You Pay, But How*, 3 3 J. APP. CORP. FIN. 36 (1990) (viewing incentive compensation as device to reduce agency costs).
action problems—will lead them to incur principal costs when they try to hold agents accountable in the exercise of that authority.

c. Mistargeting

Even when shareholders retain power to hold directors accountable, as is true in most public corporations, the vast majority of shareholders do not take an active role in exercising that power.63 Rather, they leave that job to specialists. In the last several decades, these “accountability specialists” have come in two main types: hostile raiders and activist hedge funds. Instead of holding a small block of shares in a diversified portfolio, these entities take relatively concentrated positions in corporations that they target for control contests. In so doing, raiders and activists have the capacity to reduce agency costs. But they also can generate a type of principal cost that we here call “mistargeting.”

Mistargeting occurs when a raider or activist contests control at a corporation in a way that causes it to switch to an inferior business vision. In Part II we described two reasons why such a switch might happen: short-termism due to myopic markets, and short-termism due to asymmetric information. Management teams pursue their business visions, and some unique or high-quality visions are more complex to execute or harder for shareholders to evaluate than others. A firm might at times underperform or be undervalued compared to peers or some other benchmark. When this happens, the firm’s directors might find themselves under attack by a raider or activist hedge fund. The shareholders then need to decide if the underperformance is the result of agency costs, or instead is due to market undervaluation, which can result from market myopia or asymmetric information. If the answer is agency costs, then the shareholders should side with the raider or activist by tendering their shares or giving their proxies. But if the answer is undervaluation, then the shareholders should side with the incumbent directors and deny control to the challenger. The market undervaluation will eventually correct itself, and the true value of the directors’ superior business vision will become evident.

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63 This is due to “rational apathy.” See Robert C. Clark, Vote Buying and Corporate Law, 29 CASE W. RES. L. REV. 776, 779 (1979) (identifying shareholders’ rational apathy); F.H. Easterbrook & D. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 66-67 (1991) (“[W]hen many are entitled to vote, none expects his votes to decide the contest.”).
Principal costs occur in this scenario when the shareholders make the wrong choice. And if the mistargeting risk is high enough, management teams might abandon underappreciated business visions in order to stave off control contests altogether. In this way, the mistargeting of one firm can cause diversified shareholders to suffer negative externalities elsewhere in their portfolios.

As an example of how shareholders can incur principal costs by exercising an accountability mechanism instead of waiting, the story of Apple’s board’s firing of Steve Jobs immediately comes to mind. There are, however, many other examples. The story of Henry Ford illustrates how the complexity of a manager’s business vision can cause investors to underestimate that vision’s inherent value. Ford did not invent the automobile, nor did he own any valuable intellectual property in the technology. At the beginning of the twentieth century, he was competing with hundreds of other entrepreneurs who were attempting to create a “horseless carriage.” He did, however, have a unique vision of car production. Outside investors controlled the first firm he founded, the Detroit Automobile Company. When these investors demanded that cars be immediately produced and sold, Ford insisted that the design first be perfected, leading to delays, frustration on both sides, and the investor’s eventual decision to shut the firm down. Did these shareholders successfully minimize agency costs, or did they make a

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64 See, e.g., Huasheng Gao, Jarrad Harford, and Kai Li, Investor Myopia and CEO Turnover: Evidence from Private Firms (working paper draft) (2013) (“We conclude that, contrary to the arguments that there is too little turnover risk for CEOs in public firms, public firm CEOs are fired too frequently, possibly due to investor myopia creating pressure on public firm boards”).

65 Apple’s board authorized then-CEO John Sculley to fire Steve Jobs in 1985 largely because of the commercial failure of Macintosh Office. Jobs proposed that the company cut the price of its struggling computer and shift its advertising resources to support the Macintosh Office. Sculley did not trust Jobs’ instinct and went to the board, which, after comparing Jobs’ proposal versus Sculley’s, forced the one-day savior of Apple to step down. Sculley later admitted that he had not realized the power of Jobs’ passion and vision and could not appreciate Jobs’ leadership as a founder. See, Randall Lane, “John Sculley Just Gave His Most Detailed Account Ever Of How Steve Jobs Got Fired From Apple,” Forbes, Sept. 9, 2013 11:32 a.m., available at http://onforb.es/1akpdJU.

66 Similar stories such as Jack Bogle who was fired from managing the Wellington Management Company and returned to transform Vanguard into the largest mutual fund company in America, and Jon Luther whose investors closed a food chain he managed, Benchmark, only for him to become the turn-around CEO of Popeye’s and Dunkin Donuts, are part of a book by Rick Newman, REBOUNDERS: HOW WINNERS PIVOT FROM SETBACK TO SUCCESS, Chpts. 3 & 4 (2012).

mistake in the exercise of an accountability mechanism, thereby incurring principal costs?

Investors also controlled the Henry Ford Company, Ford’s second attempt. Once again, after designing a car, Ford resisted investor pressure to move directly into production. His obstinacy led investors to replace Ford with Henry Leland and change the firm’s name to the Cadillac Automobile Company. Leland then produced the car that Ford had designed, which met with great success.  Here again, did shareholders successfully reduce agency costs, or did they incur principal costs? Notably, proponents of hedge-fund activism point to such cases as demonstrations of how activism can reduce agency costs. But history tells us a different story.

In his third attempt—the Ford Motor Company—Ford insisted on retaining control. This time, with no outside investor interference, he transformed his ideas for car design and production (his business vision) into one of history’s great commercial success stories. Although investors in what had become the Cadillac Automobile Company made money after firing Ford, they would have made much more had they stayed with him. The Ford story illustrates that principal costs due to mistargeting can be very high even when performance apparently improves. The improvement does not establish that shareholders exercised control effectively. The Ford story is rare: although there are cases showing how firms who said “no” to a hostile raider performed later, history does not usually reveal how shareholders fared in the counterfactual world in which a displaced management team was permitted to pursue its original business vision.

It is with a view to minimizing the sum of the risks of agency costs and principal costs that investors and managers design a corporate governance structure. As we will see, there is no one particular welfare-optimizing regime. Rather, a structure that is right

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68 Id. at 45.
69 Id. at 47.
70 Two examples of firms that outperformed after turning down a hostile takeover bid are Illumina, which rejected Roche’s $6.7 billion offer and outperformed its competition by 247%, and Airgas, which defended against Air Products & Chemicals’ $5.8 billion offer and went on to beat its peers by 20.8%. Steven Davidoff Solomon, “The Consequences of Saying No to a Hostile Takeover Bid,” NEW YORK TIMES (Oct. 28, 2014 4:10pm), available at http://dealbook.nytimes.com/2014/10/28/the-consequences-of-saying-no-to-a-hostile takeover-bid/.
for one type of business may be ill-suited for another, leading to a wide spectrum of choices.

d. The Governance-Structure Spectrum

In structuring a firm, investors and managers must allocate two different types of rights: control rights and equity rights. Control rights govern the allocation of authority over the full range of decisions that could arise in the course of running a business. The balance between delegation and accountability discussed above is a function of the division of control rights between investors and managers. The effect is that, in divvying up control rights, investors and managers must choose some mix of principal costs and agency costs. More delegation to managers reduces principal costs (including the costs of mistargeting) but increases agency costs; less delegation has the converse effect. While it is impossible to create an accountability mechanism that simultaneously reduces both costs, a mechanism’s effectiveness at minimizing the sum of the two costs will differ across corporations, depending on factors such as the type of business, the industry, and the identity of the managers and investors. The division of equity rights (claims on profits) between investors and managers runs in parallel to the division of control rights. The division of equity rights determines, on the one hand, investors’ risk and expected returns and, on the other hand, management’s compensation and incentives. Both control rights and equity rights are fixed pies, making their division between investors and managers a zero-sum proposition. Different allocations of control rights and equity rights manifest as a spectrum of governance structures that reflect different tradeoffs between agency costs and principal costs. We present the spectrum by starting on the pole where the managers have all of the control.

i. Dual-Class

On one end of the spectrum is the corporation with the dual-class share structure. In such a corporation, management holds shares with superior voting rights, and outside

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71 Equity cash-flows, as oppose to equity rights, are not a zero-sum proposition. Different allocations of equity rights might be more efficient than others thus yielding more cash flows.
shareholders have inferior or no voting rights.\textsuperscript{72} Google and Facebook are notable current examples of firms with dual-class shares.\textsuperscript{73} Control is held entirely by management, and accountability is limited. Shareholders cannot interfere in business decisions or fire the board. While shareholders can sell their shares, they cannot withdraw their investments from the firm.\textsuperscript{74} For these reasons, neither activist hedge funds nor hostile raiders can force the managers of a dual-class firm to change their business vision.

In the absence of direct accountability mechanisms, shareholders can try to reduce agency costs by requiring the managers to own a large share of the claims on profits—on average 40%.\textsuperscript{75} Still, we can expect agency costs to be high in dual-class firms due to the lack of accountability mechanisms.\textsuperscript{76} But, for the same reason, management enjoys complete freedom to pursue its business vision, causing principal costs to be low.\textsuperscript{77} Thus, the dual-class structure might be attractive in situations where shareholders acknowledge management’s unique skills and vision. Nonetheless, it is an extreme choice on the menu of potential governance structures. Indeed, at least in the United States, firms with a dual-class structure are rare.\textsuperscript{78}

\begin{footnotes}
\item[72] For example, assume that 1 share out of 10 has 51\% of the votes, while the remaining 9 have together 49\% of the votes. Each share has an equal claim to profits. The entrepreneur owns the super-share (51\% of the votes and 10\% of profits), and investors own the remaining shares (49\% of votes, 90\% of profits).
\item[74] Selling shares in the market does not reduce a firm’s capital; it merely shifts equity from one owner to another. By contrast, the withdrawal of capital by an investor shrinks the pool of assets under management’s control.
\item[75] See, e.g., Paul A. Gompers, Joy Ishii, & Andrew Metrick, Extreme Governance: An Analysis of Dual-Class Firms in the United States, 23 REV. FIN. STUD. (March 2010).
\item[77] See, e.g., Scott B. Smart, Chad J. Zutter, Control As a Motivation for Underpricing: A Comparison of Dual- and Single-Class IPOs, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236107 (finding that dual-class firms experience less underpricing, higher post-IPO institutional ownership, and less frequent control events than single-class firms, but trade at lower multiples).
\item[78] See Robert M. Daines & Michael Klausner, Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs, 17 J. L. ECON. & ORG. 83 (2001) (finding that only 6\% of IPO firms have dual-class
\end{footnotes}


**ii. Master Limited Partnership**

Next along the spectrum is the master limited partnership ("MLP") structure. 79 An MLP is organized as a partnership in which management serves as the general partner and the outside investors are limited partners. Management has a small proportionate equity holding in the MLP and yet enjoys complete control. Investors cannot interfere in business decisions or replace managers, and MLPs are not vulnerable to hostile takeovers. However, MLPs are unlike dual-class firms in that their shareholders have the benefit of an accountability mechanism: the MLP is required to pay yearly dividends. Consequently, accountability is achieved by limiting management’s authority to retain and reinvest earnings without shareholders’ consent.

**iii. Private Equity**

Moving further along the governance structure spectrum brings us to private equity funds. 80 Like MLPs, these entities are organized as partnerships, with the management team as the general partner and the investors as limited partners. They also are similar to MLPs in that the managers have relatively small equity holdings and yet exercise complete control. 81 Investors can neither vote managers out nor replace them through a hostile takeover. On the other hand, managers are entitled to exercise authority over the fund for only a limited period, normally ten years. 82 In addition, the proceeds

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79 A master limited partnership is a type of partnership that is publicly traded. The partnership has two types of partners, limited partners who provide capital and receive distributions, and the general partner who is responsible for managing the partnership. Master limited partnerships must fulfill a specific set of legal criteria in order to be so characterized. See “Rise of the distorporation,” THE ECONOMIST (Oct. 26, 2013) available at http://www.economist.com/news/briefing/21588379-mutation-way-companies-are-financed-and-managed-will-change-distribution (describing the increasing popularity of the master limited partnership, and some of its benefits such as pass through taxation and significant upside for general partners).

80 A private equity is an investment vehicle in which normally only accredited investors invest. The fund then invests in buying either complete ownership or control positions in a portfolio of firms depending on its declared strategy (size, industry, etc.). See Steven N. Kaplan & Per Stromberg, Leveraged Buyouts and Private Equity, 23 J. ECON. PERSP. 121, 121 (2009) (generally reviewing private equity firms).

81 See id. at 126 ("[A]fter committing their capital, the limited partners have little say in how the general partner deploys the investment funds, as long as the basic covenants of the fund agreement are followed.").

82 See Andrew Metrick & Ayako Yasuda, The Economics of Private Equity Funds, 23 REV. FIN. STUD. 2303, 2309 (2010) ("[T]he typical fund has a lifetime of ten years, with [managers] allowed to make investments in new companies only during the first five years.").
from realized investments must be returned to investors immediately, even if the fund has not reached its termination date. The limitation on the fund’s duration constitutes an exit right, enabling investors to cut off management’s control over capital. And the obligation to distribute realized investments acts like a mandatory dividend rule, limiting the scope of funds under management’s control. A similar structure is used by venture capital funds.

**iv. Hedge Funds**

Next along the spectrum are hedge funds. Like private equity funds, hedge funds are limited partnerships in which management with relatively small equity holdings has complete control for a fixed period, usually seven to ten years. Investors cannot interfere in business decisions or replace management. While hedge funds are not required to distribute realized investments, their investors typically have quarterly or annually withdrawal (i.e., exit) rights. In this way, investors can hold managers accountable by threatening to terminate authority over the investors’ capital. More extreme exit rights exist in an open-end mutual fund, from which investors can exit anytime the market is open.

**e. The Governance Structure Spectrum as a Tradeoff Boundary**

The above description of the variety of governance structures seems to suggest a one-dimensional spectrum in which the different structures are placed along a line moving from more to less accountability. However, a fuller interpretation of the nature of

83 Id.
84 Venture capital funds are a type of private equity fund that focuses on early stage, high-potential and high-growth companies (aka start-ups). They usually are partnerships in which the limited partners have very little say over the choice of investment. The investments are, however, limited in duration.
85 Here we refer to the structure of the hedge-fund (i.e., the relationship between the investors in the fund and the managers of the fund) as oppose to its investment activity (i.e., the relationship between the fund and the corporations it holds in its portfolio). See Houman B. Shadab, The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection, available at: http://ssrn.com/abstract=1066808 (providing a detailed description of hedge funds structure).
86 Id. at page 251.
87 An open-end mutual fund is a regulated-investment-vehicle that allows all types of investors to invest in the fund. The fund has a manager that invests the funds according to its disclosed strategy and the regulation’s guidelines in tradable securities. Investors can invest in the fund or withdraw their investment anytime that the stock market is open. See, e.g., Vikram Nandaa, M.P Narayana, & Vincent A Warther, Liquidity, Investment Ability, and Mutual Fund Structure, 57 J. Fin. Econ. 417 (2000).
governance structures recognizes that the depiction of the spectrum might treat the inescapable tradeoff between principal costs and agency costs as defining an outer boundary beyond which it is impossible to reduce one type of cost without increasing the other. We might call this boundary the “tradeoff boundary.” When parties adopt a corporate governance structure, we can presume that their goal is to place their firm on this tradeoff boundary. The degree of delegation that minimizes the sum of the two costs will differ across firms, depending on factors such as the type of business, the industry, and the identity of the managers and investors.

**Figure One: The Tradeoff Boundary**

Figure One depicts principal costs and agency costs as two dimensions that define a space in which governance structures can be placed. The space is bounded on two sides by the tradeoff between principal costs and agency costs. This framework implies that there is no particular governance structure that can be described as intrinsically good, bad, welfare-enhancing, or inefficient. A structure that is right for one type of business may be ill-suited for another. Indeed, not every firm can be placed anywhere on the

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88 In an analogy to the “efficiency frontier” in finance theory, this tradeoff boundary can be thought of also as the “presumptive efficiency frontier”.

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tradeoff boundary and still function efficiently. For instance, a firm with widely dispersed shareholders cannot function efficiently as a direct democracy.

Given this spectrum, where should the corporation with the dispersed-ownership structure be placed on the tradeoff boundary? As we show in the next part, the answer depends on whether lawmakers permit control of such corporations to be contested.

IV. The Dispersed-Ownership Governance Structure

a. Dispersed-Ownership with Accountability

None of the governance structures discussed so far enable investors to vote out directors. In other words, investors in these structures can sell their interests, and they may be able to exit by withdrawing capital from the firm, but they have no voice. Voice does not emerge on the spectrum until we reach the dispersed-ownership structure, the most common structure among public corporations in the United States. 89

The dispersed-ownership structure is unique in that corporate control over major business decisions and the “big picture” business vision is contestable. While other governance structures may give managers complete control and insulation—either indefinitely (in a dual-class firm) or for a fixed period (as in a private equity fund)—control of a dispersed-ownership firm is contestable by shareholders through the exercise of the shareholder franchise. While management is normally entrusted to make the day-to-day business decisions (normally the CEO’s realm of authority) as well as many important business and governance decisions (the board’s realm of authority), 90 shareholders can, through majority vote, veto decisions by the board to merge the firm, sell all of its assets, or dissolve it. 91 Additionally, and most importantly for our purposes,

90 Del. Gen. Corp. L. § 141(a) (granting expansive board authority).
91 See Del. Gen. Corp. L. § 271 (requiring a shareholder vote for the sale of substantially all of the corporation’s assets); Del. Gen. Corp. L. § 251 (requiring majority shareholder approval of mergers).
shareholders can exercise the franchise to elect and remove directors. As a result, shareholders can, by replacing directors (or threatening to), alter the firm’s business vision.

A shareholder who wishes to change the direction of a corporation can win a contest for control in one of two ways. He can either buy enough additional shares of the corporation to own a majority or he can persuade a sufficient number of other shareholders to support his proposal in a proxy contest. The first strategy is pursued by hostile raiders; the second, by activist hedge funds.

i. Hostile Raiders

Hostile raiders typically begin a control contest by buying a toehold stake in the target—usually about 10% of the outstanding shares—on the open market. Then, to build that stake into a majority of shares, the raider makes a tender offer. If the offer is successful, the raider can use the voting power appurtenant to his control block to replace the board and implement his alternative business vision. Alternatively, the raider could decide that the incumbent managers’ business vision is fundamentally sound, in which case the raider could leave the managers in place and capture the upside for himself.

ii. Activist Hedge Funds

Like raiders, activist hedge funds invest resources searching for underperforming firms and devising strategies for improving their performance. Once an activist fund identifies a suitable target for a control contest, it, like a raider, typically builds up about a 10% equity stake through stock-market purchases. But instead of then making a tender offer, the activist initiates, or threatens to initiate, a proxy contest. Thus, the fund asks for other shareholders’ support in replacing incumbent directors, in increasing dividend distributions, or otherwise forcing a change in the firm’s capital or governance structure. Regardless of the substantive nature of its proposal, the activist operates through the mechanism of shareholder voting.

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93 See Kahan & Rock, supra note 3.
The different strategies pursued by activists and raiders imply different tradeoffs between principal costs and agency costs. As we will show in the discussion that follows, when hostile raiders are the main challengers to control of dispersed-ownership firms, both agency costs and principal costs will tend to be moderate. When, on the other hand, activists are the main challengers, agency costs will tend to be lower but principal costs will tend to be higher. Notably, with both types of challengers the tradeoff between principal costs and agency costs is quite different from the tradeoff offered by the dual-class structure.

iii. Activist Hedge Funds and Raiders Compared

To see how activists and raiders affect both principal costs and agency costs, it is useful to imagine a simple economy that has three types of dispersed-ownership firms. First, high-quality firms are pursuing superior business visions that, when fully realized, will deliver above-market returns to their shareholders. Such business visions might be long-term and complicated to execute and difficult for the market to evaluate. Second, average-quality firms are pursuing middling business visions that will deliver average shareholder returns. Such business visions are simpler to execute and easier for the market to price. And third, low-quality firms are pursuing inferior business visions that will deliver below-average returns. Such business visions are the result of agency costs. In this economy, control challengers—be they raiders or activists—create value for diversified shareholders—and for society generally—by targeting low-quality firms and transforming them into average-quality firms. When this happens, agency costs fall. The control challenger turns a profit if the market prices the shares of the target firm accurately both before and after a successful control contest. When that occurs, the challenger can acquire the shares pre-contest at a low price and sell them post-contest at a higher price.

There is, however, a hazard in this economy: the hazard of mistargeting. A challenger might target a high-quality firm by mistaking it for a low-quality firm. This might occur when the market is undervaluing the firm, pricing it as if it were pursuing an inferior business vision. Undervaluation could occur due to myopic markets or asymmetric information; the distinction is not important for purposes of this analysis. The
challenger might fail to recognize that the firm’s incumbent directors are pursuing a superior business vision, and the challenger therefore imposes a middling business vision in its place. Consequently, the market will correctly price the shares of the firm after the challenger forces a change to a simpler business vision. And the challenger will turn a profit, because it caused the target firm’s market price to rise. But the challenger has destroyed value because the firm would have provided a higher return had its directors been allowed to continue pursuing their original, superior business vision. This result is very much like replacing Henry Ford with Henry Leland and then selling Ford’s car design as Cadillac with great (apparent) success. But because (unlike in the Ford case) the counterfactual result will not actually occur, market observers will not be able to distinguish successful targeting from mistargeting. Although challengers can profit from mistargeting, diversified shareholders and the economy in general will suffer a loss. These losses result from principal costs that can arise in the dispersed-ownership structure when activists and raiders have the power to contest management control.

As this discussion indicates, control challengers are a double-edged sword. They reduce agency costs, but they also can increase principal costs. But raiders and activists are not equal in this regard. We review here some of the ways in which their business models differ, and the implications of these differences for the principal cost/agency cost tradeoff.

Control challengers must incur what we will call “shifting” costs: the costs of shifting a target firm from one business vision to another. A hostile raider’s shifting costs have three components: research to identify a target, execution costs, and the large premium that the raider must offer other shareholders to induce them to tender. Empirical studies indicate that a raider’s total shifting costs typically equal about 60% of the

94 See Coffee & Palia, supra note 5 (analyzing the effect of a probable mistake in the joint targeting of the pharmaceutical company Allergan by the raider Valeant and the hedge-fund activist Pershing Square. “Arguably, hedge funds are only enforcing the market’s apparent skepticism about long-term R&D investments in the pharmaceutical industry. Yet, a Pershing Square can profit whether or not a Valeant’s strategy succeeds, and that ability to profit from a mistake poses the deeper issue with hedge fund activism: namely, it is often riskless.” P.46
target’s pre-raid market capitalization. Notably, these high costs mean that a raid is worthwhile only if the raider can effect a very large increase in the target’s value.

Shifting costs for an activist are much lower. The costs consist of research to select a target, and the expenses of a proxy fight in which the activist tries to convince other shareholders to support the activist’s proposal. Empirical studies indicate that the activist’s expenses in the typical proxy fight are about $5 million, a price tag that does not vary much with the size of the target. Therefore, an activist’s shifting costs tend to be lower than a raider’s, with the difference widening as the target increases in value. The implication is that activists have a much lower “hurdle rate”: the minimum percentage improvement in the target’s share price necessary to make targeting profitable. And, because they have lower hurdle rates than raiders, activists should be able to target a wider range of firms. Put another way, agency costs have to reach a minimum level at a firm before targeting the firm is worthwhile, and that minimum is higher for raiders than for activists. Moreover, the advantage that activists have over raiders in policing agency costs will generally increase with the size of the target.

Although the large premium that raiders must offer limits the range of underperforming firms they can target, the premium provides an offsetting benefit, in that it compensates diversified shareholders for at least some of the losses that they might suffer due to mistargeting. Thus, both raiders and activists might mistarget a firm, replacing a high-quality vision with a middling business vision. A raider, however, partly compensates diversified shareholders against this risk by paying them a premium for their shares. The compensation will be even greater if the announcement of a tender offer puts

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95 Michael C. Jensen, Takeovers: Their Causes and Consequences, 2 J. Econ. Perspectives 21 (1988) (average premium paid to target shareholders is about 50%).
97 As an illustration, consider a target firm whose total market capitalization is $1 billion. Assume that an activist hedge fund can successfully target the firm by acquiring a 10% share block and then spending $5 million dollars to win a proxy fight. On these assumptions, the overall value of the target needs to improve by at least $50 million, or 5%, in order for the activist to turn a profit (assuming the market prices the firm’s shares accurately). By contrast, a hostile raider will have to spend 1.6 x $1 billion = $1.6 billion in order to buy 100% of the shares in a tender offer. Therefore, the raider will have to expect to increase the value of the target by at least $600 million, or 60%, to turn a profit and make the raid worthwhile. If we assume an even larger target, the activist’s hurdle rate falls further, but the raider’s does not, on the assumption that the activist’s switching costs vary less with the target size’s than the raider’s do.
the target “in play,” causing other raiders to bid higher amounts. Activists offer no such compensation, suggesting that they impose higher principal costs on diversified shareholders than raiders do.

To prevent mistargeting, diversified shareholders can try to screen challengers. They can refuse to tender to a raider or to give their proxies to an activist. How effective will this screening be? When it comes to raiders, shareholders have little incentive to incur expenses to prevent mistargeting. The reason is the premium that the raider offers, which compensates shareholders against at least some of the potential mistargeting costs. Thus, when a premium is offered, most shareholders will tender.

Since activist hedge funds do not offer shareholders a premium, they give those shareholders more reason to screen. And we can expect that recent market changes have made screening of activists more effective. Institutional shareholders, who are generally considered sophisticated, now own a large proportion of the shares of public corporations. Moreover, securities regulation has increased the amount and quality of information supplied to the market, and market efficiency has increased over the years as

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98 See Gilson, supra note 92.
99 See Gordon, supra note 16.
100 Not only will activists likely impose higher principal costs on diversified shareholders, but they will also impose higher principal costs on a society as a whole. Managers of a targeted firm will naturally try to save their jobs by persuading the challenger that the firm is, despite a low share price, pursuing a superior business vision. Once a raider has 100% of a target’s shares, the incumbent managers can divulge everything they know to the raider without running afoul of insider trading laws, fiduciary duties, and other concerns. Therefore, if a firm has hidden value, the raider is likely to realize it. By contrast, managers cannot divulge inside information to an activist that owns only 10% of the shares. The activist is therefore less likely to realize that hidden value exists, and is more likely to conclude that agency costs are the reason for the underperformance of the firm’s share price. It follows that activists are more likely to destroy hidden value than raiders are. Additionally, raiders are less likely to destroy value through mis-targeting because they internalize the full costs of doing so, and therefore will be willing to spend more investigating the firm’s business plan to confirm that it is not superior. Activist internalizes only a fraction of the principal costs that result from mis-targeting, and therefore is more likely to engage in mis-targeting. In this way, raiders will impose lower principal costs both on diversified shareholders and on society as a whole.

101 Moreover, even before the tender offer closes, a substantial portion of the shares (perhaps 40%) will be purchased by arbitrageurs who assume the risk that the tender offer will not be completed. These arbitrageurs generally do not evaluate the incumbent management’s business vision against the premium offered, but rather estimate the probability of a successful tender and its price. Their final goal is to tender.
102 See Gilson and Gordon, supra note 60.
well. Despite these changes, there are several reasons to suspect that screening still does not prevent all instances of mistargeting by activist hedge funds. First, not all institutional investors invest in information. Most prominently, index funds invest nothing in being informed. Second, even informed institutions will not hold large enough share blocks to justify becoming more informed than the hedge-fund activist. Indeed, it is only because the institutional investor is insufficiently informed, or is committed to an indexing strategy, that it might hold low-quality firms in its portfolio in the first place. Third, many activist funds now pursue the “wolf pack” tactic, whereby multiple funds target the same firm, thereby acquiring, in combination, a large share block. Since the members of the wolf pack tend to vote together, the “lead wolf” (the fund that initiated the control contest) can succeed by persuading only a small fraction of the other shareholders to give their proxies. The bottom line is that the factors that lead diversified shareholders to delegate authority to directors—insufficient information, conflicts of interest, and collective-action problems—also make them unlikely to be effective screeners of activists.

When all relevant factors are considered, it becomes apparent that the level of agency costs and principal costs in dispersed-ownership firms will depend on whether raiders or activist funds are the main threats to managerial control. Because raiders incur higher shifting costs, they have higher hurdle rates and thus will be less effective at reducing a wide range of agency costs. Because, however, most of a raider’s shifting costs consist of the tender-offer premium, which can be bid up by competition, raiders impose lower principal costs on diversified shareholders than activists do. On the other

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104 Index funds are a passive investment vehicle aiming at replicating a given market index (e.g., S&P 500, NASDAQ 100) by purchasing the securities composing the given index. Anna Agapova, Conventional Mutual Index Funds Versus Exchange-Traded Funds, 14 J. Fin. Markets 323 (2011).

105 See Gilson and Gordon, supra note 60.

106 Thomas W. Briggs, Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis, 32 J. Corp. L. 681, 685 (Summer 2007); Coffee & Palia supra note 5.

107 Coffee & Palia supra note 5.

108 And raiders also impose lower principal costs on society generally because they are more likely to uncover and preserve hidden value.
hand, activist funds have lower hurdle rates because they offer no control premium. Consequently, activists produce lower overall agency costs but higher principal costs.

In considering the full impact of raiders and activists on diversified shareholders, it is important to note that a challenger need not target a firm in order to influence its managers. The fear of being targeted could cause the managers of a low-quality firm to adopt a better business vision. But fear of targeting could also cause the managers of a high-quality firm to abandon a superior business vision whose value the market does not appreciate. In this way, raiders and activist funds can impose both positive and negative externalities on diversified shareholders who hold shares in firms that are never actually targeted. Since activists are the greater threat to the business visions of both low-quality firms and high-quality firms, they will impose larger externalities, both positive and negative, than raiders will.

b. Dispersed-Ownership Without Accountability

What does the tradeoff between agency costs and principal costs look like in dispersed-ownership firms if neither activist funds nor hostile raiders are capable of contesting control? The question is not merely academic. Most opponents of shareholder activism do not advocate revitalization of the hostile takeovers market, which would require Delaware courts to relax or abandon their “substantive coercion” doctrine. Rather, the opponents want to continue to allow boards to use the poison pill to “just say no” to hostile bids, and at the same time they want lawmakers to erect, or allow boards to deploy, barriers to activists as well.

Without activism or hostile takeovers, the only threat to the directors of a widely-held corporation is a proxy fight led by a shareholder who owns a small equity stake. Because such an investor will have to bear the full cost of the proxy fight if he loses, but

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109 See Coffee & Palia, supra note 5, p.44 (“Equally important, the significance of this apparent hedge fund distaste for long-term investment in research and development (at least in the pharmaceutical industry) appears not to have been missed by other corporate managers in this industry. A Financial Times survey in July, 2014, noted a “fundamental trend” in this industry: namely, that pharmaceutical and household consumer products companies are divesting their non-core divisions and “reassessing their portfolios.”). The survey is available at Scherazade Daneshku, Andrew Ward and Adam Thomson, “Drugmakers juggle non-core assets,” Financial Times, July 25, 2014, at 13.

110 This is a doctrine that allows boards wide discretion to block hostile raiders. See infra Part V.a.i.

111 See infra Part V.a.i-ii.
will only capture a small fraction of the benefits if he succeeds, he is very unlikely to profit from contesting control in this way. Unsurprisingly, the threat that shareholders with small holdings pose to directors of widely-held corporations is extremely low.\textsuperscript{112} Indeed, Professors Ronald Gilson and Jeffrey Gordon have observed that institutional investors are as well highly reticent to initiate proxy fights.\textsuperscript{113}

As a practical matter, then, a widely-held corporation whose directors are safe from both activists and raiders is much like a dual-class firm. Shareholders of such firms have no effective accountability mechanism. Principal costs will therefore be low, but agency costs will be high. Indeed, agency costs may be even higher than in a dual-class firm because management of dual-class firms typically hold a larger portion of the firm’s equity than management of dispersed-ownership firms.\textsuperscript{114}

To be sure, hostile raids against Delaware corporations are not altogether impossible now, the “substantive coercion” doctrine notwithstanding. Thus, even though shareholders cannot unilaterally change a corporation’s charter, they have recently been successful in pressuring many firms to de-stagger their boards.\textsuperscript{115} And shareholders also have often succeeded in changing corporate bylaws to require that poison pills expire after a year unless ratified by a majority shareholder vote.\textsuperscript{116} It is important to note, however, that shareholders have achieved these results mainly through the threat of activism.\textsuperscript{117} Therefore, closing the door to activism would also slam shut the door to raiders, which the activists have been holding ajar.

\textsuperscript{112} See Gilson & Gordon, supra note 60.
\textsuperscript{113} See Gilson & Gordon, supra note 60.
\textsuperscript{114} C. Holderness, R. Kroszner, & D. Sheehan, Were The Good Old Days That Good?: Evolution Of Managerial Stock Ownership And Corporate Governance Since The Great Depression, 54 J. Fin. 435 (1999) (finding that the aggregate ownership by officers and directors of a single publicly traded firm is on average 21%).
\textsuperscript{115} Weili Ge, Lloyd Tanlu, & Jenny Li Zhang, Board Destaggering: Corporate Governance Out of Focus? available at: http://ssrn.com/abstract=2312565 (efforts led by the Harvard Law School Shareholder Rights Project and proxy advisory firms like Institutional Shareholder Services has led to the recent wave of destaggering boards).
\textsuperscript{117} Ge, et al., supra note 115 (finding that firms under more pressure from active shareholders are more likely to destagger their boards).
c. Dispersed-Ownership on the Tradeoff Boundary

Where should the corporation with dispersed-ownership structure be placed on the tradeoff boundary introduced above? In comparison to the dual-class share structure, where agency costs are high due to the lack of investor accountability mechanisms and principal costs are low due to the complete freedom management enjoys to pursue its business vision, a corporation with a dispersed-ownership structure has relatively lower agency costs, since investors can hold managers accountable through exercising the voting power to remove directors, but higher principal costs, since those same accountability mechanisms can lead to mistargeting. Figure B thus portrays the expected theoretical position of the dispersed-ownership corporate structure on the tradeoff boundary.

![Figure Two: Dispersed Ownership on the Tradeoff Boundary]

In this figure, principal costs and agency costs define a space in which governance structures can be placed, and following the above analysis we place the dispersed-ownership in the middle.
The Tradeoff Boundary and the Role of Lawmakers

When attempting to choose an optimal corporate governance structure for a particular business enterprise, parties may diverge in opting for more or less complete contracts based on the relative balance of ex ante and ex post contracting costs.\(^{118}\) Their choice is either to write a detailed contract that leaves narrow enforcement discretion for courts in the future, or to write an incomplete contract that leaves wide enforcement discretion for courts in the future. On the front end, uncertainty about the future and the difficulty of describing ex ante all the possible contingencies may lead parties to write incomplete contracts, relying instead on renegotiation or litigation in the future.\(^ {119}\) In the design of corporate governance structures, parties could accept courts’ enforcement of fiduciary duties. On the back end, the cost of verifying compliance and enforcing agreements may lead to more complete contracts. In our context, if the parties wish to deny courts any role beyond simple contractual interpretation, they can select an LLC and contract out of fiduciary duties in the LLC agreement.\(^ {120}\) This is an example of relying on ex ante contracting. If they instead form a corporation, with its obligatory fiduciary duties for directors,\(^ {121}\) the implication is that they have opted for a governance structure that gives courts the power to interpret their agreement ex post.

While a dispersed-ownership structure provides courts with wide ex post enforcement discretion, all the aforementioned governance structures rely on ex ante contracting that leaves court very narrow enforcement discretion. For instance, a contract establishing a private equity fund is a very detailed contract, specifying the respective rights of the management and the investors. Whatever balance between principal costs and agency costs was chosen by the parties, the court is expected simply to enforce it. In


\(^{120}\) See Del. Lim. Liab. Co. Act §18-1101(c)(d) (permitting the fiduciary duties of agents to be “expanded or restricted or eliminated” in the LLC agreement).

\(^{121}\) The general incorporation statutes of Delaware and most other states circumscribe the power of parties to contract around fiduciary duties. The corporation typically can, in its charter, renounce its interest in specified business opportunities. See Del. Gen. Corp. Law §122(17). Otherwise, the full set of fiduciary obligations for directors (loyalty, care, good faith) is mandatory, save that directors can be immunized against personal liability (but not shielded from injunctive relief) for violations of the duty of care, so long as the directors did not engage in a knowing violation of law. See Del. Gen. Corp. Law §102(b)(7).
contrast, the dispersed-ownership structure is an incomplete governance structure, relying mostly on corporate law default rules and *ex post* judicial enforcement of fiduciary duties.

Why would the parties who adopt the corporate governance structure want to give judges such a high degree of latitude? We believe that the choice of the corporate form reflects parties’ recognition that, because corporations have indefinitely long lives, circumstances will change in unforeseeable ways. The industry in which the firm operates will probably change, as will the identity of its key players and the broader legal and economic environment. Investors and managers therefore may want the assistance of judges, and perhaps lawmakers more generally, in updating their governance structure in response to these changed circumstances.

In Figure Three we add another element to explain the role of lawmakers. Within the space bordered by the tradeoff boundary, the various governance structures are now grouped into three categories, which differ in the degree to which they delegate power to managers. Category I consists of low-delegation arrangements, in which agency costs are low but principal costs are high. Category II consists of medium-delegation arrangements, in which there are moderate levels of both principal costs and agency
costs. And Category III consists of high-delegation arrangements, in which principal costs are low but agency costs are high.

The arrow in Figure Three describes the role of judges and the category areas define the realm in which they have discretion to update a governance structure. We argue that, while judges have some latitude, each governance structure’s basic division of control between managers and investors establishes a border that the judges must not cross. Changing circumstances can cause a corporation’s governance structure to drift off the tradeoff boundary: when that happens, judges should update fiduciary duties to return the firm to the tradeoff boundary. Judges should not, however, issue rulings that transform a firm from one basic category of governance structure to another.

Our claim about the boundaries of courts’ discretion is based on concerns of both efficiency and autonomy. We start with the efficiency reasoning. All firms seek to maximize expected profits. The decisions of an overwhelming majority of firms to choose a dispersed ownership structure with moderate principal costs and moderate agency costs should serve as a warning to lawmakers to avoid regulations that would radically transform the chosen governance structure. Moving a firm from one category to another carries with it substantial risk that such a move will in fact shift the firm even farther away from the tradeoff boundary. This risk is especially high in the case of the most common corporate governance structure in the US, the dispersed ownership structure. The fact that only a small minority of firms finds it efficient to occupy Category I and Category III (the extreme poles), while the clear majority of firms occupy Category II (the middle), suggests that the risk of inefficient move from the middle category to any of the two other extreme categories is very high.

Moreover, as explained above, the choice of a governance structure is a choice about the relative exposure to principal costs and agency costs. These two costs have a major effect on the performance of the firm in selecting an optimal business strategy and executing it properly. Thus, the selection of a governance structure affects the business

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122 See Alan Schwartz and Robert E. Scott, Contract Theory and the Limits of Contract Law, 113 YALE L. J. 541, 550–55 (arguing that all parties to a contract seek to maximize joint gains and that contract law should facilitate the ability of firms to maximize welfare when making commercial contracts).
performance, much like the choice of the business strategy itself or the choice of how to finance the firm. Courts acknowledge that interference with business and financing decisions is prone for mistakes and thus, but for the extreme cases of irrational decisions, abstain from interference by applying the business judgement rule. Courts understand that coping with management agency costs (i.e., inefficient performance) is better left for the parties (i.e., shareholders and managers) to privately resolve. We argue that courts should acknowledge that interference with the selected governance structure is similarly prone for mistakes and thus apply the same degree of caution they apply to business decisions. Courts should limit their discretion to adjusting the governance structure within its selected category, and avoid extreme interventions that transform a firm to a completely different category of governance structure. A major adjustment to the governance structure, if necessary, should be left for the parties to privately accomplish (through either renegotiations or a management buyout).

Our argument is also based on autonomy. The basic governance structure of a firm is a form of contract, which should be respected based on grounds of autonomy. Even if courts are certain about their ability to avoid mistakes when moving a firm to a different category and still successfully place the firm on the tradeoff boundary, they should abstain from doing so. In other words, courts should respect the autonomy of the parties in selecting to affiliate with a given governance structure even when the choice is not grounded on efficiency considerations. A close parallel to our case is the “efficiency frontier” in finance theory, as our tradeoff boundary curve can also be viewed as “presumptive efficiency frontier.” In finance theory all portfolios on the efficiency frontier are similarly efficient (i.e., the frontier is also the indifference curve). However, it is clear that investors with different tastes will choose different portfolios on the efficiency frontier. While investors who do not like risk will choose a portfolio with low-risk/low-return, investors who prefer risk will choose high-risk/high-return portfolio. The

fact that finance theory shows that these two portfolios are equal does not justify forcing investors who do not like risk to own a risky portfolio. Although no financial harm is caused through such forced move, conservative investors’ autonomy is harmed with all the other non-financial utility values it carries with it. We argue that the same is true for a forced move from one category of governance structure to another. Courts should respect the autonomy of the parties in choosing a given governance structure.

V. Implications

In this part we consider our governance structure framework’s implications for the debate over whether Delaware courts and the SEC should tamp down on shareholder activism. Our analysis indicates that the parties in a corporation with a dispersed-ownership structure are in governance structure in which shareholders have some means for contesting the board’s exercise of control. Had they wanted instead for the board to be completely insulated, they would have adopted a dual-class structure, which has been in use for decades. Therefore, the parties would not have wanted lawmakers to block both shareholder activism and hostile takeovers, as these have proven to be the only two effective means for contesting control of dispersed-ownership firms. As we saw in the last part, a widely-held firm lacking both accountability mechanisms offers essentially the same agency-cost/principal-cost tradeoff as a dual-class firm, except that agency costs will likely be even higher because directors of widely-held firms typically lack large equity stakes.

To be sure, our framework has not told us which accountability mechanism—activism or raiders—a firm’s founders would have intended. They might have preferred one mechanism to the other, depending on the desired mix between agency costs and principal costs; they also might have preferred that both mechanisms be available. The question of which mechanism they intended to be available cannot be answered only by comparison to other governance structures. But our framework does indicate that denying shareholders both accountability mechanisms will nullify contestable control, a core term of the dispersed-ownership structure.
a. Implications for Delaware Courts

The “Substantive Coercion” Doctrine: In cases involving hostile raids, Delaware courts have developed the “substantive coercion” doctrine, which empowers a board to block a tender offer by claiming that the price offered by the raider is inadequate.\textsuperscript{124} Delaware Chancery courts adopted the doctrine while applying the Delaware Supreme Court’s 1985 decision in \textit{Unocal Corp. v. Mesa Petroleum Co},\textsuperscript{125} which established the test for evaluating anti-raider defensive measures. Under the \textit{Unocal} test, a board may employ defensives measures if the directors have determined in good faith that a takeover bid poses a “threat” to the corporation.\textsuperscript{126} A court’s acceptance of the board’s subjective view that a tender offer is a “threat” because the price is inadequate is the essence of the substantive-coercion doctrine. Because shareholders who agreed with the board’s characterization of the bid would not tender, the substantive-coercion doctrine allows a board to thwart a tender offer on the premise that shareholders who would tender would be making a mistake. Using our terminology, the board is claiming that the raider is mistargeting. The doctrine therefore endorses the view that raiders can profit from short-termism at the expense of long-term investors. Given directors’ natural incentive to try to hold onto their jobs, one can safely assume that boards almost never acknowledge that a hostile bid is fairly priced.

The \textit{Unocal} test also purports to regulate the types of defensive measure that directors can employ. Even if a raider poses a threat to the corporation, directors must not use measures that are “preclusive or coercive.”\textsuperscript{127} In practice, however, this second prong of \textit{Unocal} has proven toothless, as courts have permitted boards to use poison pills

\textsuperscript{124} The term “substantive coercion” was coined by Ronald Gilson and Reinier Kraakman in their 1989 article \textit{supra} note 25. It was then adopted by the Delaware courts. \textit{See e.g., Paramount Commc’ns, Inc. v. Time Inc.}, 571 A.3d 1140, 1153 n.17 (Del. 1989); Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1383–1385 (Del. 1995)[hereinafter \textit{Unitrin}]; Air Products and Chemicals, Inc. v. Airgas, Inc., 16 A.3d 48, 96–98 (Del. Ch. 2011)[hereinafter \textit{Airgas}].

\textsuperscript{125} \textit{Unocal Corp. v. Mesa Petroleum Co.}, 493 A.2d 946 (Del. 1985).

\textsuperscript{126} Id. at 955.

\textsuperscript{127} A defensive measure is coercive “if it is aimed at ‘cramming-down’ on its shareholders a management-sponsored alternative.” \textit{Airgas}, 16 A.3d at 113 (quoting Unitrin, 651 A.2d at 1387). A defensive measure is preclusive if it “makes a bidder’s ability to wage a successful proxy contest and gain control [of the target’s board] ... ‘realistically unattainable.’” \textit{Id. (quoting Versata Enterprises, Inc. v. Selectica, Inc.}, 5 A.3d 586, 610 (Del. 2010)).
simply to veto tender offers.\(^{128}\) Indeed, Delaware courts have found that a poison pill coupled with a staggered board is not “preclusive or coercive,” notwithstanding that a board shielded by that combination of defensive measures is essentially impregnable.\(^ {129}\)

Because they both employ the accountability mechanism accorded by the shareholder franchise, hostile raiders and activist hedge funds are, to some extent, substitutes for each other. Therefore, by using the substantive coercion doctrine to allow directors to thwart raiders, Delaware courts shifted the market for corporate control into the hands of the activists. We are not saying that this shift was what Delaware courts intended,\(^ {130}\) nor that other changes in the economic and legal landscape did not also play a role.\(^ {131}\) But regardless of the explanation, the activist hedge funds have arrived in force, confronting Delaware courts with new legal challenges.

**The New “Disproportionate Control” Doctrine:** Just as boards can now use poison pills to block hostile raiders,\(^ {132}\) they also can lower the trigger threshold on a pill to block activists as well. An example of how is provided by the recent battle for control of the famous auction house Sotheby’s. An activist fund holding a 9.6% share block ran a

\(^{128}\) See *Unitrin*, 651 A.2d at 1388–1391 (holding poison pill not coercive or preclusive).

\(^{129}\) See, Lucian A. Bebchuk, John C. Coates IV, & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 Stan. L. Rev. 887, 889 (2002) (“In combination with an effective staggered board . . . a pill provides significant antitakeover protection: the pill blocks any stock acquisition beyond the trigger level, and the staggered board forces the bidder to go through two proxy contests in order to gain control of the board and redeem the pill.”); Lucian A. Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 976–77 (2002) (arguing that boards should not have veto power in takeover bids); Black & Kraakman, *supra* note 43 (stating that “[n]either the finance literature nor the norms of corporate law support vesting such unbalanced power in the hands of the board”); *But see* Versata Enterprises, Inc. v. Selectica, Inc., 5 A.3d 586, (Del. 2010) (expressing the permissibility of a poison pill combined with a staggered board); *Airgas*, 16 A.3d at (same).

At the same time that Delaware courts applied a lenient standard of review to allow boards wide discretion to block takeovers, they applied a much more stringent standard of review as to efforts by boards to interfere with shareholder elections of directors. Any board interference with the power of shareholders to elect directors requires a showing of “compelling justifications.” Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988). Over time, however, the application of Blasius was restricted in many ways, such that now, it is, practically, only a reflection of the “preclusive or coercive” prong under Unocal review. Mercier v. Inter-Tel (Del.), Inc., 929 A.2d 786, 807 (Del. Ch. 2007).

\(^{130}\) For a study showing such a relationship, *see*, Martijn Cremers & Allen Ferrell, *Thirty Years Of Shareholder Rights And Firm Valuation*, J. Fin. (2013) (finding negative association between restrictions on shareholder rights and Tobin’s Q only appearing after the judicial approval of antitakeover defenses in the 1985 landmark Delaware Supreme Court decision of Moran v. Household. “This decision was an unanticipated, exogenous shock that increased the importance of shareholder rights.”).

\(^{131}\) See Gilson & Gordon, *supra* note 60.

\(^{132}\) See *supra* note 23.
proxy fight against Sotheby’s board, proposing to elect three new directors at the annual shareholder meeting. To improve its likelihood of success, the fund hoped to increase its equity stake to 20%. But Sotheby’s board adopted a poison pill with a lower trigger for activists (10%) than for passive investors (20%). In the ensuing lawsuit the Delaware Chancery judge sided with the board,\(^\text{133}\) accepting its argument that the activist presented two cognizable threats: “creeping control”\(^\text{134}\) and “negative control.”\(^\text{135}\) In so doing the court applied the *Unocal* test,\(^\text{136}\) which, as we noted above, was designed in cases involving hostile raiders. By applying *Unocal* in a different context, the court established

\(^{133}\) See Third Point LLC v. Ruprecht, 2014 WL 1922029, at *17 (Del. Ch. May 2, 2014) (“[The Activist Fund] posed a threat of forming a control block for Sotheby's with other hedge funds without paying a control premium.”).

\(^{134}\) See id. at *21 (“[T]he concept of negative control addresses situations in which a person or entity obtains an explicit veto right through contract or through a level of share ownership or board representation at a level that does not amount to majority control, but nevertheless is sufficient to block certain actions that may require, for example, a supermajority vote.”).

\(^{135}\) See id. (“Plaintiffs are correct that the Delaware case law relating to the concept of negative control addresses situations in which a person or entity obtains an explicit veto right through contract or through a level of share ownership or board representation at a level that does not amount to majority control, but nevertheless is sufficient to block certain actions that may require, for example, a supermajority vote.”).

\(^{136}\) Although the court was actually making new law, it treated the matter as “old law.” Indeed, the citations the court provided for showing the old law, in its footnote 38 of the case, do not support this claim. We list here the cases cited as they appeared in that footnote, and in the brackets we have added how negative control played in each case. Loral Space & Commc’ns Inc. v. Highland Crusader Offshore P’rs, L.P., 977 A.2d 867 (Del. 2009) (while affirming the grant of high attorney’s fees in the case cited below with the same parties, the court ruled that where the facts support both a class action and a derivative claim, stockholders may litigate both at the same time); In re Trados Inc. S’holder Litig., 73 A.3d 17 (Del. Ch. 2013) (inconsequential use of the words “negative control” in a paragraph citing the testimony of one of the defendants); Balch Hill P’rs, L.P. v. Shocking Techs., Inc., 2013 WL 588964 (Del. Ch. Feb. 7, 2013) (granting motion for expedited proceedings to appoint a receiver or custodian for a corporation, in a case where one director could prevent a quorum by not attending board meetings and used this power to frustrate resolutions needed to save the corporation from financial difficulties); Johnston v. Pendersen, 28 A.3d 1079 (Del. Ch. 2011) (the defendant directors breached their fiduciary duties when issuing the Series B Preferred Stock with a veto right over the replacement of the board, although they honestly believed they were acting in the best interests of the company because the stock issuance was structured to prevent an insurgent group from waging a successful proxy contest); Miller v. Miller, 2008 WL 372469 (Del. Ch. Jan. 31, 2008) (declining to appoint without full trial a custodian for a corporation in which a family dispute created a deadlock over the appointment of directors); In re Loral Space & Commc’ns Inc., 2008 WL 4293781 (Del. Ch. Sept. 19, 2008) (self-dealing and breach of duty of loyalty when the board raised equity from an effective controlling shareholder with preferential terms, including veto rights and complete control, without a market check); In re IAC/InterActive Corp., 948 A.2d 471 (Del. Ch. 2008) (holding that a contract granting a high voting class of shares special rights did not prevent a spin-off of four subsidiaries with only one class of shares); Bentas v. Haseotes, 769 A.2d 70 (Del. Ch. 2000) (appointing a custodian for a Delaware corporation where the shareholders were deadlocked on the election of some, but not all, of the directors); Odyssey P’rs, L.P. v. Fleming Co., 735 A.2d 386 (Del. Ch. 1999) (holding that a board did not breach its duty of loyalty in a chain of events culminating in the purchase in an open foreclosure sale of the corporation’s main asset by the controlling shareholder, who was also the sole secured creditor over all corporate’s assets).
a new doctrine that aims at the heart of shareholder activism. We call this the “disproportionate-control” doctrine. Thus, the court accepted the board’s argument that waiving the pill “could effectively allow [the activist] to exercise disproportionate control and influence over major corporate decisions, even if [the activist lacks] an explicit veto power.”137 But of course, achieving “disproportionate control” through a proxy fight is the essence of the activist strategy. This new doctrine could thus shut down activism as an accountability mechanism, just as “substantive coercion” disabled hostile tender offers.138 The case settled before it reached the Delaware Supreme Court, and so we must wait for another case to learn if the disproportionate-control doctrine is the official law of Delaware.

Perhaps because they develop their control-contest doctrines case by case, Delaware courts seem not to have realized how those doctrines work in combination. But they need to adopt a synthesized view, because allowing boards to block both raiders and activists would contradict the governance structure between shareholders and managers implied by the dispersed-ownership structure. If Delaware courts believe that activist hedge funds are a problem, they must also decide if activists are a bigger problem than raiders. If the answer is yes, and the courts want to close the door to activists, they must simultaneously reopen the door to raiders by relaxing the substantive-coercion doctrine.

The argument we advance here is different from the one most often advanced by activisms’ proponents. In particular, we do not rest on an empirical assertion that the risk of short-termism risk is insignificant. Rather, our argument is that the parties who affiliate with a firm should be allowed to decide in the first instance how much importance they wish to accord short-termism and other potential principal costs. They

137 For instance, the court accepted that waiving the pill “could effectively allow those persons to exercise disproportionate control and influence over major corporate decisions, even if they do not have an explicit veto power.” Third Point, 2014 WL 1922029, at *21. This statement, however, is true in any hedge funds activism.

138 Acknowledging the sweeping implications of its ruling, the court observed that the “notion of effective, rather than explicit, negative control obviously raises some significant concerns, chief among them being where does one draw the line to ensure that effective negative control does not become a license for corporations to deploy defensive measures unreasonably.” Id. at *22. Despite this caveat, the essence of the court’s ruling is that there is nothing “unreasonable” about the use of a poison pill that aims at the heart of activist hedge funds’ business model.
do this by selecting from the menu of governance structures that offers different tradeoffs between principal costs and agency costs. While in a dual-class structure the parties have adopted complete board insulation (with low principal costs and high agency costs), in a dispersed-ownership structure they have adopted contestable control (with lower agency costs and higher principal costs). Of course, every time the risks of each structure materialize (e.g., high agency costs in a dual-class firm; higher principal costs in a dispersed-ownership firm), the *ex ante* choice of the parties will seem inefficient. Courts may then think it is reasonable to rewrite the contract to achieve an arguably more efficient result. But courts should enforce contracts, even incomplete ones, according to the parties’ *ex ante* intentions. And parties who selected dispersed-ownership did not intend the dual-class structure. 139

b. Implications for the Securities and Exchange Commission

Rule 13d of the Williams Act requires an investor who acquires 5% or more of a public firm’s outstanding shares to disclose that fact publicly and also to reveal his intentions. 140 Currently, the deadline for making the disclosure is ten days after the investor crosses the 5% threshold. During this ten-day window, an activist fund generally tries to increase its stake in the target company as much as possible. Once the window closes and the fund announces its intentions, the company’s share price inevitably spikes, 141 and acquiring additional shares becomes uneconomical. Corporate boards are now lobbying the Securities Exchange Commission (“SEC”) to shorten this window from ten days to one; their goal is to shrink the share blocks that activists can acquire. 142 Since the shifting costs that an activist fund must incur are fixed, but its potential for profits


141 *See* Coffee & Palia, *supra* note 5 (reviewing the evidence).


As we have seen, shareholders and managers who wanted completely insulated directors could have selected a dual-class structure. But boards would also be fully insulated in dispersed-ownership firms if lawmakers were to put both activists and hostile raiders out of business. Therefore, as long as Delaware maintains its substantive-coercion doctrine, the SEC cannot shorten the Rule 13d window without undermining the agreement between shareholders and directors implied in the choice of the dispersed-ownership structure. When combined with the doctrine of substantive coercion, a shortened Rule 13d window would transform all dispersed-ownership firms into \textit{de facto} dual-class firms.

c. Hedge-Fund Activism Revisited

These implications for hedge fund activism can be clearly depicted with reference to the tradeoff boundary. As mentioned above, our thesis emphasizes the role of courts in enforcing the basic agreement embodied in the corporate governance structure. In this conception of the corporation, the role of courts (and potentially other lawmakers) is to help corporations remain close to the tradeoff boundary, but not to shift them from one category to another. The general choice between low-delegation (Category I), medium-delegation (Category II) and high-delegation (Category III) arrangements must be respected because they are appropriate for different types of firms, and the parties who affiliate with a corporation are presumptively better positioned than judges to determine which category serves a particular firm best. But the parties will also recognize that, during the corporation’s indefinitely long lifespan, there will be unforeseeable changes in the identity of the owners, the nature of the industry, and the economic and legal environment generally. These changes could cause the corporate governance structure to drift away from the tradeoff boundary, increasing costs along one dimension without reducing them along the other. When this happens, courts can use the flexibility accorded
by fiduciary duty law to update the governance structure, pushing it back toward more efficiency. However, the courts’ discretion is bounded by the basic terms of the governance structure: in updating it, courts cannot upset the fundamental division of power between principals and agents implied by the corporation’s governance structure. The role of courts (and potentially other lawmakers) is to help corporations remain close to the tradeoff boundary, but not to shift them from one category to another. The categories must be respected because they are appropriate for different types of firm, and the parties who affiliate with a corporation are presumptively better positioned than judges to determine which category serves a particular firm best.

As an illustration of the distinction between proper and improper action by lawmakers under this view of the corporate governance structure, consider the box in Figure Four labelled “Dispersed: Contestable.” The box represents the dispersed-ownership structure when raiders and activist are able to contest control. The structure occupies Category II, where shareholders have delegated a large amount of authority to directors but also retain potent accountability mechanisms. For much of the twentieth century, we might assume that this governance structure was close to the tradeoff boundary. However, as the market for tender offers picked up in the 1960s, raiders began
using abusive practices that seemingly drove up principal costs without delivering a commensurate decrease in agency costs. Raiders used brief offer periods and structurally coercive pricing to exploit a collective-action problem among shareholders. As a result, many shareholders may have tendered not because they thought the price was right, but simply because they feared that their shares would be worth even less if they failed to tender promptly.

We can interpret these developments in the market for tender offers as causing the dispersed-ownership structure to drift away from the tradeoff boundary. Under this interpretation, the role of lawmakers was to push the structure back toward the tradeoff boundary, while at the same time preserving the basic balance of power inherent in the dispersed-ownership arrangement. In this sense, Congress acted appropriately when it passed the Williams Act in 1968, which prohibited certain abusive practices in tender offers while preserving the ability of raiders to use the tender offer to challenge corporate control. The Delaware Supreme Court similarly acted in a manner consistent with this role in *Unocal*, where it permitted management to employ defensive measures to thwart a structurally coercive, two-tier tender offer. Such changes in the law can be seen as moving the dispersed-ownership structure along Figure Four’s arrow A, nudging it back towards the tradeoff boundary while preserving the basic allocation of power between shareholders and directors that defines Category II.

Similarly, the direction indicated by arrow A might now represent recent developments in the strategies of activist hedge funds—in particular, the rise of the “wolf pack,” whereby multiple funds invest in a target firm’s shares at the same time. This tactic potentially raises principal costs by undercutting the screening function that institutional shareholders play when they refuse to lend their support to an activist they suspect is mistargeting. Wolf packs undermine screening because the other members of the pack share the “lead wolf’s” short-term investment horizon, whereas institutional investors hold shares for longer periods, and therefore will see the value of their diversified portfolios fall if mistargeting occurs. Under this interpretation, it might be proper for lawmakers to permit management to employ defensive measures that curb the wolf-pack tactic. Such a change might nudge the dispersed-ownership structure back
toward the tradeoff boundary without fundamentally altering the basic allocation of power between directors and shareholders.

Arrow B, by contrast, represents what would be improper action by lawmakers. If Delaware courts were to allow directors to employ low-trigger pills to fight off all control contestants (raiders and activists), or if the SEC were to use the Williams Act to make activism unprofitable, lawmakers would effectively be transforming a “Category II” dispersed-ownership structure into a “Category III” dual-class structure. In so doing, while lawmakers might earnestly believe that they were aiding investors by reducing the total sum of principal costs and agency costs, their actions would nonetheless be improper because they would be overstepping the line established by the corporate governance structure chosen by the parties. Such an extreme move carries with it substantial risk of placing firms even farther away from the tradeoff boundary, especially when moving firms from the most common middle Category II to the extreme Category III. Additionally, if lawmakers are to respect the autonomy of the parties to privately order their business affairs, parties must retain the power to select Category II, as they are better positioned than lawmakers to decide whether that category provides the right division of power for their particular firm. Judges must not interpret fiduciary duties, and regulators must not issue rules, that would empty out that category altogether.

CONCLUSION