The Most Important Theory in Corporate Law is Useless: Agency Cost Theory Explains Anything and Predicts Nothing

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ABSTRACT

Agency cost theory provides the conceptual scheme most often used to understand the governance of corporations and the proper relationship of various corporate actors. It is, by far, the most important theory of the firm in corporate law and finance. Thousands of law review and finance articles take it as an article of faith and use it to explain almost everything that occurs in business corporations. But in practice, the theory functions as a retrospective "just so" story, capable of providing ad hoc explanations of any outcome. Its attempts at predicting behavior over the past forty or so years have largely ended in failure.

This paper looks at the recent empirical literature on almost twenty governance practices (everything from takeovers to say on pay voting) that bear on the major predictions historically drawn from agency cost theory. A large body of empirical evidence calls each of these predictions into question, suggesting that agency cost theory is not actually getting at anything important to corporate law and governance. In other words, it does not tell us anything about how corporations should be regulated or run.

DOI: https://doi.org/10.15779/Z38MS3K308

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INTRODUCTION

Agency cost theory is, by most measures, the most successful academic theory of the last century in law and finance. The two papers popularly understood to set it out in its modern form are among the most cited articles in finance.[1] The theory undergirds a vast and growing body of empirical research that, but for it, would probably not exist. It now serves as the organizational schema of corporate law and its influence on real world legal and regulatory developments over the past forty years has been incalculable. But is agency cost theory actually true?

I. A HISTORY OF AGENCY COST THEORY

As far back as Adam Smith, it has been understood that when the corporate form results in some persons managing the wealth of others, there is a risk of inefficiency. In his famous work, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Smith wrote that managers would not watch over others' resources "with the same anxious vigilance" one would expect of owners, and that "negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."[2] The well-known debates among Adolph Berle, Merrick Dodd, and Gardiner Means in the first decades of the twentieth century also drew attention to the separation of ownership and control, along with the possibility that mangers might have interests that diverged from those of the shareholders.[3]

Surprisingly, prior to the 1980s, little real intellectual, regulatory, or governance activity followed these insights.[4] For their part, Berle and Means were more interested in the political and social implications of the separation of

1. The two papers are: Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structur*e, 34 J. FIN. ECON. 305 (1976) and Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323 (1986) [hereinafter Jensen, *Free Cash Flow*]. *See* Angelito Calma, *The 'Celebrities' in Finance: A Citation Analysis of Finance Journals*, 34 STUD. IN ECON. & FIN. 166, 173 (2017). *See also* Brian R. Cheffins, *What Jensen and Meckling Really Said About the Public Company*, RSCH. HANDBOOK OF CORP. PURPOSE AND PERSONHOOD 2, 3 (2021) [hereinafter Cheffins, *Jensen and Meckling*] (showing that Google Scholar reports more than 90,000 citations to *Theory of the Firm*).

2. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 324 (1776).

3. ADOLFE A. BERLE JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933); Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); E. Merrick Jr. Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Adolf A Berle, *For Whom are Corporate Managers Trustees: A Note*, 45 HARV. L. REV. 1365 (1932). *See also* William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737 (2001) (comparing Berle and Means changes in the political economy and its effect on labor unions over the last 50 years) [hereinafter Bratton, *Berle & Means*].

4. *See* George J. Stigler & Claire Friedland, *The Literature of Economics: The Case of Berle and Means*, 26 J.L. & ECON. 237 (1983); Andrew Smith, Kevin Tennent & Jason D. Russell, *The Rejection of Industrial Democracy by Berle and Means and the Emergence of the Ideology of Managerialism*, 43 ECON. & INDUS. DEMOCRACY 98 (2019) https://doi.org/10.1177/0143831X19883683.

ownership and control than its impact on business performance. Indeed, their analysis was pitched at such a high level of generality that they failed to distinguish between the board of directors and the CEO: the central power dynamic in modern understandings of the widely-held corporation.[5] In terms of outcomes, their analysis led them to espouse a managerialist philosophy, which understood a corporate executive as a kind of benevolent technocrat mediating the interests of the various constituencies that make up the modern firm.[6] In other words, their analysis led them directly away from the preoccupations of modern agency theory.[7]

Until the mid-1970s, finance scholars remained confident that managers were faithful stewards of corporate resources and generally acted to maximize corporate cash flows.[8] Eugene Fama and Merton Miller (both Nobel Prize-winning economists) referred to this belief that executives maximized the current market value of firms as "the market value rule" and observed in 1972, "[that] despite many years of controversy,…[it has not] yet been demonstrated that the market value rule leads to predictions that are so widely at variance with observed management behavior as to rule it out, even as a first approximation."[9]

There was not much academic interest in what happened inside firms. Ronald Coase observed that his pioneering 1937 investigation of what occurred inside companies, *The Nature of the Firm*, "had little or no influence for thirty or forty years after it was published."[10] Corporate governance, as a field of thought about the way organizational structures and decision-making processes inside the corporation significantly influence economic outcomes, thus did not really exist for a long time.

This is the context for the arrival of agency cost theory in the mid-1970s. In their *Theory of the Firm: Managerial Behavior, Agency Costs and the Theory of the Firm*, Michael Jensen and William Meckling accurately described the state of understanding about what occurred inside business corporations as constituting an "empty box."[11] They went on to note,

"While the literature of economics is replete with references to the "theory of the firm," the material generally subsumed under that heading is not a theory

5. Mariana Pargendler, *The Corporate Governance Obsession*, 42 J. CORP. L. 359 (2016).

6. Lynn A. Stout, *On the Rise of Shareholder Primacy, Signs of its Fall, and the Return of Managerialism (in the Closet)*, 36 SEATTLE U. L. REV. 1169, 1170-82 (2013); Harwell Wells, *'Corporation Law is Dead': Heroic Managerialism, Legal Change, and the Puzzle of Corporation Law at the Height of the American Century*, 15 U. PA. J. BUS. L. 305 (2013); Howard Brick, TRANSCENDING CAPITALISM: VISIONS OF A NEW SOCIETY IN MODERN AMERICAN THOUGHT 56 (2006).

7. William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and the Modern Corporation*, 34 J. CORP. L. 99 (2008).

8. *See* J. B. Heaton, *Corporate Governance and the Cult of Agency*, 64 VILL. L. REV. 201, 210-11 (2019).

9. Eugene F. Fama & Merton Miller, THE THEORY OF FINANCE 75 (1972).

10. Ronald H. Coase, *The Nature of the Firm: Influence*, 4 J.L. ECON. & ORG. 33 (1988).

11. Cheffins, *Jensen & Meckling*, *supra* note 1, at 306.

of the firm but actually a theory of markets in which firms are important actors. The firm is a "black box" operated so as to meet the relevant marginal conditions… Except for a few recent and tentative steps, however, we have no theory which explains how the conflicting objectives of the individual participants are brought about into equilibrium so as to yield this result."[12]

Their solution was to examine the incentives of the various constituencies inside corporations, paying attention to the internal allocations of corporate cash flows.[13] While there were others[14] writing in a similar vein in the 1970s, "most observers would agree…that Jensen and Meckling presided over the inauguration of agency theory."[15] Rejecting the view that the interests of managers and the firm were identical, agency theory, in Jensen and Meckling's formulation, characterized shareholders as principals employing executives as agents to manage the shareholders' property: the corporation. "The relationship between the stockholders and manager of a corporation fit the definition of a pure agency relationship."[16] Because managers' interests can reliably be expected to diverge from those of the shareholders, certain costs are incurred to minimize the firm resources diverted away from the shareholders. These "agency costs" were defined by Jensen and Meckling as the sum of: (1) monitoring expenses by the principal (this includes the cost of a board of directors as well as the costs incurred by shareholders in informing themselves about corporate performance and voting wisely), (2) the expense of "establishing appropriate incentives for

12. *Id.* at 306-307.

13. Bryce C. Tingle, *What is Corporate Governance? Can we Measure it? Can Investment Fiduciaries Rely on It*, 43 QUEEN'S L.J. 223, 229 (2018) [hereinafter Tingle, *Can We Measure It*].

14. *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS (1976) (arguing for the monitoring model of the board of directors) [hereinafter Eisenberg, *Structure*]; Bengt Holmstrom, *Moral Hazard and Observability*, 10 BELL J. ECON. 74 (1979) [hereinafter Holmstrom, *Moral Hazard*]; Stephen A. Ross, *The Economic Theory of Agency: The Principal's Problem*, 63 AM. ECON. REV. 134 (1973); Michael Spence & Richard Zeckhauser, *Insurance, Information, and Individual Action*, 61 AM. ECON. REV. 380 (1971); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

15. Dan R. Dalton et al., *Chapter 1: The Fundamental Agency Problem and its Mitigation*, 1 ACAD. MGMT. ANNALS 1, 6 (2007) [hereinafter Dalton et al, *Fundamental Agency Problem*]. *See* Diane K. Denis, *Twenty-Five Years of Corporate Governance Research…and Counting*, 10 REV. FIN. ECON. 191, 193 (2001); James P. Walsh & James K. Seward, *On the Efficiency of Internal and External Corporate Control Mechanisms*, 15 ACAD. MGMT. REV. 421, 422 (1990); MICHEL AGLIETTA & ANTOINE REBERIOUX, CORPORATE GOVERNANCE ADRIFT: A CRITIQUE OF SHAREHOLDER VALUE 23-32 (2005); Josh Bendickson et al., *Agency Theory: Background and Epistemology*, 22 J. MGMT. HIST. 437, 443 (2016) ("Despite the work of Berle and Means, the emergence of a coherent agency theory did not occur until the 1970s-1980s, when the theory was developed by Jensen and Meckling (1976) and Fama and Jensen (1983)"); Olivier Weinstein, *Firm, Property and Governance: From Berle and Means to the Agency Theory, and Beyond*, 2 ACCT. ECON. L. 1, 2 (2012) ("This new conception of the firm…was partly founded on a specific theorization of the enterprise, linked to the rise of contract-based theories: agency theory, first presented in the seminal article of Jensen and Meckling (1976). It would be hard to overestimate the huge practical and theoretical influence of this theory."). *But see* Barry M. Mitnick, *Origin of the Theory of Agency: An Account by One of the Theory's Originators* (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020378 (argues it was a paper by Stephen Ross and Barry Mitnick, and not Jensen and Meckling, where agency theory originated).

16. Cheffins, *Jensen & Meckling*, *supra* note 1, at 309.

the agents" (which are a type of monitoring expense),[17] (3) the bonding expenditures incurred by the agent to guarantee they will not take actions that harm the shareholders or to ensure they will be compensated if the agents do take those actions, and (4) the "residual loss," which is the unavoidable reduction of welfare experienced by the shareholders as a result of agents' decisions diverging from those that would maximize shareholder welfare.[18]

Agency cost theory both created the field of corporate governance and, in the same intellectual move, realized its implied objective: reducing agency costs as much as possible to the benefit of the shareholders.[19] As Professor Edward Rock notes, "Theoretical and empirical finance scholarship, and the standard finance textbooks, all conceptualize the corporation as run for the benefit of the shareholders."[20] The new field also supplied a unifying theory, filling an absence that had been felt for some time in corporate law.[21] The most well-known articulation of this absence was Bayless Manning's lament in 1962 that "[C]orporation law, as a field of intellectual effort, is dead…We have nothing left but our great empty corporation statutes–towering skyscrapers of rusted girders, internally welded together and containing nothing but wind."[22]

The problem is that so long as the corporation was a "black box" with little attention paid to the incentives of internal actors and the distribution of internal cash flows, corporate law scholarship was left only with evaluating the externally visible economic performance of firms, such as profitability.[23] Business corporations are extremely heterogeneous entities. They have different

17. *Id.* at 308.

18. *Id.* at 308. Note Jensen and Meckling's formal list of agency costs does not include incentives, but incentives are discussed in the section that immediately proceeds their formal list and they fit awkwardly as either a monitoring or bonding cost. As well, I include it explicitly because of incentives' importance in the subsequent history of agency theory and corporate governance. *See* discussion *infra* notes 185-227.

19. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 248-49 (1999) ("This principal-agent model, in turn, has given rise to two recurring themes in the literature: First, that the central economic problem addressed by corporation law is reducing "agency costs" by keeping directors and managers faithful to shareholders' interests; and second, that the primary goals of the public corporation is–or ought to be–maximising shareholders' wealth."). *See also* AGLIETTA & REBERIOUX, *supra* note 15 ("… reliance on [agency theory] leads to the adoption of shareholder value as the reference model…that the managerial team has been hired by the shareholders to best serve their interests." at 42). Note that shareholder primacy is not required by agency cost theory. Michael Jensen, himself, eventually proposed the long run value maximization of the firm for a wide range of stakeholders: Michael Jensen, *Value Maximisation, Stakeholder Theory, and the Corporate Objective Function*, 7 MGMT. ASS. 297 (2002) [hereinafter *Value Maximisation*]. However, for most of its existence, agency theory has been understood to characterize the providers of capital as the principals.

20. Edward B. Rock, *For Whom is the Corporation Managed in 2020? The Debate Over Corporate Purpose* 17 (Eur. Corp. Governance Inst. Law Working Paper No. 515, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3589951.

21. Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 923 (1984) ("[u]ntil recently, corporate law has been an uninspiring field for research").

22. Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 245 n. 37

23. This is not entirely true. *See generally* RICHARD EELLS, THE GOVERNMENT OF CORPORATIONS (1962).

ownership structures, very different types of boards and executive teams, they compete in radically different product markets, and deploy an extensive variety of constantly changing business strategies.[24] They face different types of competitors, suppliers and customers, dissimilar regulatory regimes, and frequent changes to the macro-economic environment that impact them differently.[25] Even the common constituencies that form around firms are radically different. There is a vast difference, for example, between the relationship of a tech company with a small, highly paid, highly educated, mostly autonomous labor force, and a manufacturer with a large, unionized workplace. The two sorts of firms may even want different things from their employees: creativity and independence in the former versus discipline in the latter.[26]

Agency cost theory allowed meaningful generalizations to be made about these companies. Notwithstanding their heterogeneity, all firms have the same internal structures: boards, executives, and shareholders, and all firms have the same object, keeping agency costs to a minimum. This commonality, revealed by agency cost theory, permitted generalizations to be made about business corporations and provided a field in which governance best practices might be discerned. Corporate governance could change from a focus on how best a company could manage its resources to succeed in various product markets (about which the average outsider could have no useful opinion) to how closely the company hewed to those best practices identified as most effective at minimizing agency costs.

The radical nature of this intellectual transition cannot be overstated. The switch from a focus on the external performance of the firm to its internal relations led to a fundamental change in how academics, regulators and corporate critics evaluated behavior. In Melvin Eisenberg's influential book, *The Structure of the Corporation*, published in the same year as Jensen and Meckling's *Theory of the Firm*, he proposed that the board's essential function was to monitor senior executives.[27] All other functions of the board—advising the CEO, generating

24. Giovanni Dosi, Sebastien Lechevalier & Angelo Secchi, *Introduction: Interfirm Heterogeneity—Nature, Sources and Consequences for Industrial Dynamics*, 19 INDUS CORP. CHANGE 1867, 1868 (2010) (despite decades of effort, one of the predominant results emerging from empirical studies is that firms are extremely heterogeneous—– no matter what dimension, there exists a persistent heterogeneity in the characteristics and dynamics of firms.)

25. Alvis Ho Ting Tang, Regularities in Firm Dynamics: The Basis of the Complex Economy (2016) (Ph.D. dissertation, Imperial College London), https://spiral.imperial.ac.uk/bitstream/10044/1/67877/1/Tang-A-2016-PhD-Thesis.pdf; William Ocasio & Nevena Radoynovska, *Strategy and Commitments to Institutional Logics: Organizational Heterogeneity in Business Models and Governance*, 14 STRAT. ORG. 287 (2016).

26. RICHARD FLORIDA, THE CREATIVE CLASS (2005).

27. EISENBERG, *supra* note 14, at 162. It should be noted, however, that Eisenberg was a critic of agency cost theory, notwithstanding his championing of a monitoring board: *see, e.g.*, Melvin Eisenberg, *New Modes of Discourse in the Corporate Law Literature*, 52 GEO. WASH. L. REV. 582, 595-96 (1984).

strategy, making introductions, authorizing major corporate decisions—were of minor importance or would seldom produce real value.[28]

Even the kind of people who could enter into discussions of corporate governance changed from corporate executives or business professors with insight into the economic realities of specific firms, to academics and critics who knew nothing about business but felt agency cost theory provided them with a clear guide by which to make judgements and propose regulatory changes.[29] Organizations such as proxy advisors, newspapers, think tanks, and magazines got into the business of judging and ranking firms' governance without any regard for their relative product market performance.[30] These outsiders were usually completely ignorant of much that a businessperson would have regarded as important about the corporation's operations, resources, competitive landscape, personalities, and strategic alternatives.[31]

Jensen and Meckling were initially only interested in describing firms, rather than advocating for dramatic changes to the ways they were governed.[32] They were admirers of the evident success of the large public company as a business form and careful readers of their initial paper came away with the impression that they regarded the governance arrangements produced by the market as optimal.[33] However, this attitude did not last. Agency cost theory very quickly went from being a description of what occurred within the black box of the firm, to being normative. Agency cost analysis "assumes that management moral hazard is the firm's only unsolved problem . . ."[34] and therefore, it seemed obvious to most observers, and eventually even to Jensen, that firms should make use of an array of devices to eliminate that hazard.[35] These structures range from efforts to empower shareholders, to the use of equity incentives to align managerial interests, to boards staffed with independent directors following

28. For history see, Harald Baum, *The Rise of the Independent Director: A Historical and Comparative Perspective* (Max Planck Private Law Research, Paper No. 16, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2814978.

29. Tingle, *Can We Measure It*, *supra* note 13. *See also* Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 889 (2007) (considering the increasing influence of the corporate governance industry).

30. *See* Tingle, *Can We Measure It*, *supra* note 13, at 260.

31. *See, e.g.,* Bryce C. Tingle, *The Agency Cost Case for Regulating Proxy Advisory Firms*, 49 U.B.C. L. REV. 725 (2016) [hereinafter Tingle, *Agency Cost Case*].

32. Cheffins, *Jensen and Meckling*, *supra* note 1, at 10.

33. *Id.* at 12-13; *see also* BRIAN CHEFFINS, THE PUBLIC COMPANY TRANSFORMED 182 (2018) (discussing the way Jensen and Meckling's "contractarian" approach "cast doubt on the need for substantial state intervention in public company governance"); *see also* William W. Bratton, *Collected Lectures and Talks on Corporate Law, Legal Theory, History, Finance, and Governance*, 42 SEATTLE U. L. REV. 755, 819 (2019).

34. William W. Bratton & Simone M. Sepe, *Corporate Law and the Myth of Efficient Market Control*, 105 CORNELL L. REV. 675, 678 (2020).

35. Cheffins, *Jensen and Meckling*, *supra* note 1 (describing Jensen's subsequent advocacy for such things as leveraged buyouts, reforms to executive pay practices, shareholder primacy, etc.).

practices designed to monitor management.[36] The strength of these recommendations in corporate governance forums is often a function of the almost total invisibility of countervailing considerations such as a failure to consider other kinds of errors (such as those made by relatively uninformed shareholders or independent directors), as well as the previously discussed lack of focus on firms' actual business performance.

The integration of this new field of corporate governance into corporate law and finance occurred relatively quickly. Agency theory began appearing in law journals in the context of corporate governance around the early part of 1978.[37] The very term "corporate governance," which had only come into existence in the 1970s, gradually began to appear in academic and popular publications.[38] (It appeared for the first time in The Economist in 1990.)[39] There are currently over 16,000 papers containing the phrase "corporate governance" found in the Social Sciences Research Network database.[40] This literature is divided between works in finance (usually empirical in nature) and works from the legal academy. Most of it depends on agency theory.[41]

There are few current debates in corporate law that are not explicitly framed in terms of agency cost theory. "The subject of most corporate law scholarship is the conflict of interests between managers (broadly defined to include directors) and shareholders. Scholars almost invariably conceptualize this conflict in terms of agency costs…"[42] Professors Goshen and Squire provide examples of the way agency cost theory is called upon in debates around executive compensation, hostile takeovers, class actions and derivative suits, director self-dealing, Delaware courts' framing of fiduciary duties, the role of institutional investors, the role of activist investors, and shareholder power to amend corporate bylaws and charters.[43] As Ronald Gilson observed, "the intellectual mission of American corporate governance took the form of a search

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36. Kenneth Lehn, *Corporate Governance, Agility, and Survival*, 25 INT'L J. ECON. BUS. 65, 65 (2018) ("There has been enormous growth in research on corporate governance during the past 35 years, most of it empirical and most of it focused on three dimensions of governance: ownership structure, boards of directors, and executive compensation.").

37. Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978).

38. Brian R. Cheffins, *The History of Corporate Governance, in* THE OXFORD HANDBOOK OF CORPORATE GOVERNANCE 46, 57 (Mike Wright et al. eds., 2013) [hereinafter Cheffins, *History of Corporate Governance*].

39. *Id*.

40. Search query for "Corporate Governance", SSRN, https://papers.ssrn.com/sol3/results.cfm (last visited May 1, 2021).

41. Lehn, *supra* note 36, at 65; *see also* Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 769 (2017) ("For the last forty years, the problem of agency costs has dominated the study of corporate law and governance."); *see also* Ronald J. Gilson, *From Corporate Law to Corporate Governance* 5-6 THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE (showing the way agency theory created the field of corporate governance and the prominence of corporate governance research in a leading finance journal).

42. Goshen & Squire, *supra* note 41, at 775.

43. *Id.* At 777-78.

for the organizational Holy Grail, a technique that bridged the separation of ownership and control by aligning the interests of shareholders and managers."[44] In this way, agency theory "became perhaps the dominant theory of the public corporation."[45]

II. THE KIND OF TRUTH THAT MATTERS FOR AGENCY COST THEORY

Agency cost theory is axiomatically true. There are always costs to employing an agent; at the very least shareholders must reconcile themselves to the need to pay corporate executives, who cannot work for free. Agency cost theory is certainly true in another way; it tells us to expect some self-interested behavior from corporate actors and this is obviously likely.[46] This paper is not about whether these relatively self-evident facts are true.

This paper is also not about whether agency cost theory is after-the-fact descriptively true, as this is not a particularly interesting question and there is probably no method of actually proving or disproving it on this basis. As various costs are hidden or incalculable, and as there are many corporate agents possessing a wide variety of interests, agency theory can retrospectively explain or justify any arrangement. As Stephen Ross noted as far back as 1987,

"The agency approach has pointed in some intriguing directions, but it fares poorly if judged by asking what it is that would be a counter observation or count as evidence against it. To the contrary, no phenomenon seems beyond the reach of "agency costs" and at times the phrase takes on more of the trappings of an incantation than an analytical tool."[47]

To see why this is so, imagine the corporate world being swept by a trend of adding members of various monastic orders to boards of directors. No matter what the measured outcome of this trend turned out to be, agency cost theory would provide an explanation. If corporate performance improved, agency cost theory would explain this by referencing their greater independence from the CEO or the monks' moral influence on self-interested managers. On the other hand, if corporate performance declined, the monks' lack of business expertise,

44. Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L. Q. 327, 331 (1996).

45. Gerald F. Davis, *New Directions in Corporation Governance*, 31 ANN. REV. SOCIO. 143, 145 (2005).

46. For criticisms that agency cost theory was not novel (and that it often amounts to just common sense), *see* William W. Bratton, *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989); Bratton, *Berle & Means*, *supra* note 3; Mark S. Mizruchi, *Berle and Means Revisited: The Governance and Power of Large U.S. Corporations*, 33 THEORY & SOC'Y 579 (2004); Stigler & Friedland, *supra* note 4; Walter Werner, *Corporation Law in Search of its Future*, 81 COLUM. L. REV. 1611 (1981).

47. Stephen A. Ross, *Finance, in* THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 29 (John Eatwell, Murray Milgate & Peter Newman, eds., 1987). S*ee also* Heaton, *supra* note 8 ("An outcome–often one that is far from obviously tied to an agency problem–that seems reasonable can always be explained by solutions to the asserted agency-cost problem; an outcome that seems unreasonable can always be explained by residual losses from agency costs that could not be controlled.").

their dependence on managers for information, and the existence of whatever social and economic ties brought them to the board in the first place, could all be deployed to explain the results. In this way, agency cost theory could explain any outcome. "When all these [agency cost] arguments hinge on asserted costs that are unobservable, the resulting explanations may be no more than 'just so stories.'"[48] This paper is not about whether agency cost theory is *descriptively* true. Rather, it is about whether agency cost theory is *normatively* true. Does it tell us anything useful about how corporations *should* be run?

In addition, this paper is not interested in whether the agency relationship is an accurate characterization of the roles of shareholders, officers and directors.[49] Shareholders may only poorly meet the criteria for a "principal,"[50] and there may be many other constituencies that also deserve that title.[51] Managers may also

48. Heaton, *supra* note 8, at 212.

49. *See, e.g.*, Heaton, *supra* note 8 ("The corporation creates a separation of ownership (of shares) and ownership (of assets) that is critical to the success of the large firm." at 220); Luh Luh Lan & Loizos Heracleaous, *Rethinking Agency Theory: The View from Law*, 35 ACAD. MGMT. REV. 294 (2010) ("redefining the principal from shareholders to the corporation, redefining the status of the board from shareholders' agents to autonomous fiduciaries, and redefining the role of the board from monitors to mediating hierarchs" at 294).

50. Bratton & Sepe, *supra* note 34; Goshen & Squire, *supra* note 41 (suggesting "principal costs are more fundamental than agent costs…" at 771); Heaton, *supra* note 8 ("[S]hareholders are not principals…[s]hareholders own shares,…not the corporation and not its assets." at 204). *See also* José-Miguel Gaspar, Massimo Massa & Pedro Matos, *Shareholder Investment Horizons and the Market for Corporate Control*, 76 J. FIN. ECON. 135 (2005) (noting that "it does make a difference who the shareholders are" because "managers face a tradeoff between targeting acquiescent short-term shareholders who are not committed to the company and targeting demanding long-term shareholders who can give them a strong hand at a merger negotiation table" at 138); Deborah J. Lucas & Robert L. McDonald, *Shareholder Heterogeneity, Adverse Selection, and Payout Policy*, 33 J. FIN. QUANT. ANAL. 233 (1998) (illustrating the "nature of possible conflicts among shareholder clienteles about the firm's dividend/repurchase policy" at 240-241); Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 816–17, 894 (2006) (discussing the consequences of decision making when separating voting rights from equity ownership); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) (explaining that shareholder interests are "insufficiently homogenous to allow the use of shareholder-centered, consensus-based forms of corporate decision making" 1745 n 54) [hereinafter Bainbridge, *Director Primacy*]; Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013) (addressing the reasons that "[m]utual funds and other for-profit investment managers are almost uniformly reticent" at 889-895) [hereinafter Gilson & Gordon, *Agency Capitalism*]; Lucian A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693, 1720–1723 (1985) (describing shareholders' strategic considerations in making a tender decision); Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 3, 47–55 (1988) ("[A]pproval of a recapitalization can be driven by strategic considerations that distort shareholder choice rather than by a collective judgment that approval is optimal for public shareholders." at 50).

51. Claire A. Hill & Brett H. McDonnell, *The Agency Cost Paradigm: The Good, the Bad, and the Ugly*, 38 SEATTLE U. L. REV. 561 (2015) (discussing how a focus on shareholders leads to short-termism); Jose Allouche & Patrice Laroche, *A Meta-Analytical Investigation of the Relationship Between Corporate Social and Financial Performance*, 57 REVUE DE GESTION DES RESSOURCES HUMAINES 18 (2005); Michael Bradley et al., *The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads*, 62 L. & CONTEMP. PROBS. 9 (1999). Jensen, himself, eventually criticized agency theory's initial focus on shareholders: Jensen, *Value Maximisation*, *supra* note 19 (arguing for "enlightened stakeholder theory"); Francesco Guerrera, *Welch Denounces Corporate Obsessions*, (Mar. 13, 2009), THE FINANCIAL TIMES, https://www.ft.com/content/294ff1f2-0f27-11de-

not stand in something very much like an actual agency relationship to *any* constituency.[52] Firms may be more than just a nexus of contracts.[53] We would not care about these abstract failures if agency cost theory were normatively true. If it generated hypotheses that turned out to improve real world economic outcomes, it would not matter very much that, as a metaphor, agency costs applied only awkwardly to a body of corporate law and theory that developed for centuries before agency cost theory arose in the 1970s.

For similar reasons, this paper is not concerned with the limitations of Jensen and Meckling's work as a model.[54] Anyone who has read their principal works recognizes that they consciously presented a partial equilibrium model, scrupulously identifying many assumptions required for the model to work.[55] Again, all models are simplifications of more complex realities, and we would not care about the shortcomings of such an approach if the agency cost model nevertheless generated hypotheses that proved useful.[56]

This paper is interested in only one question: does the theory work? Agency cost theory was quickly understood to suggest certain things about the real world and to imply ways to make it better. This was, as far as the record shows, the nearly universal assumption among lawyers, regulators, and finance academics. It is impossible to read any part of the vast literature that has grown out of agency

ba10-0000779fd2ac ("shareholder value is the dumbest idea in the world…shareholder value is a result, not a strategy…your main constituencies are your employees, your customers and your products.").

52. Ann M. Lipton, *What we Talk About when we Talk About Shareholder Primacy*, 69 CASE W. RSCH. L. REV. 863 (2019) (discussing conflicts in shareholder objectives that result in the law freeing directors from the narrow obligation to effect those objectives) [hereinafter Lipton, *Shareholder Primacy*]; LYNN A. STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC (2015) (arguing that directors' duties are owed to the corporation, not to shareholders, and since directors also decide what purposes the entity will pursue, they are, in a way, agents of themselves); American Law Institute, Restatement of the Law of Agency: As Adopted and Promulgated by the American Law Institute at Washington, DC, May 4, 1933 (St Paul: American Law Institute Publishers, 1933) ("directors are neither the shareholders' nor the corporation's agents as defined in this section, given the treatment of directors within contemporary corporate law in the United States." at 1.01 cmt F(2)); Joseph L. Bower & Lynn S. Paine, *The Error at the Heart of Corporate Leadership*, HAR. BUS. REV., (May-June 2017), https://hbr.org/2017/05/managing-for-the-long-term ("managers are fiduciaries (rather than agents)…"); Stephen M. Bainbridge, *Responses: Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) (noting the conflicts among shareholders that would make acting as their agent impossible); Paul B. Miller & Andrew S. Gold, *Fiduciary Governance*, 57 WM. & MARY L. REV. 513 (2015) ("The powers of the fiduciary, and the objects for which he acts, are specifiable entirely with reference to one or more abstract purposes without it being necessary to identify a beneficiary, much less the particular interests or preferences of that beneficiary" at 517-18).

53. Michael J. Meurer, *Law, Economics, and the Theory of the Firm*, 52 BUFF. L. REV. 727 (2004) ("the nexus of contracts approach to corporate law has generated valuable insights, but this literature has created the false impression that agency theory captures the essence of the theory of the firm" at 731).

54. Lehn, *supra* note 36 (noting that "[i]t is likely that, for some firms, governance structures that promote agility, even at the expense of higher agency costs, improve overall firm performance and increase the chances of survival." at 1-2).

55. *See* Bratton & Sepe, *supra* note 34, at 686-87 (discussing variables left out of Jensen and Meckling's model); Lehn, *supra* note 36 (noting resiliency is left out of the model).

56. *See* MILTON FRIEDMAN, ESSAYS IN POSITIVE ECONOMICS 86 (1953) (arguing that what matters is not that economic theories reflect reality, but that they accurately predict outcomes).

cost theory without encountering the (usually implied) assumption that the theory is a guide to how the real world works and how it might be improved.

The development of agency cost theory almost immediately generated numerous hypotheses. Over the past forty years, we have duly tested all of them. What is the result?

III. TESTING THE HYPOTHESES GENERATED BY AGENCY COST THEORY

From the outset, there were broadly accepted implications of agency theory that were understood to fall out of the theory. These implications were not the only ones that might have gained traction. For example, it is possible to conclude from agency cost theory that a major problem in corporate governance is the role of shareholders when they are empowered by corporate law to act as agents of the corporation. This occurs when they vote, make proposals, wage proxy fights, or collectively decide to sell the business. They have interests that may diverge from the corporation as a whole, as well as from each other. This is not merely hypothetical, this sort of agency-cost argument has been made.[57] However, this is not how agency cost theory was generally understood. To the contrary, almost from the beginning, it was anticipated that increasing shareholder power relative to managers was an important part of reducing agency costs.[58] As this was the generally accepted implication of agency cost theory, and as it reflects the clear trend in corporate governance regulation over the past thirty years, the hypothesis we will test in this paper is whether increasing shareholder power leads to improved governance.[59] We will follow the same rule of looking at the most important and influential hypotheses that fell out of agency cost theory.

A further note about the method we will be following is in order. The empirical literature around the various agency cost hypotheses is vast and, if viewed uncritically, often contradictory. Indeed, there are legal academics who

57. This argument is made, for e.g. Goshen & Squire, *supra* note 41 (though they call it "principal costs" in deference to the general understanding shareholders are principals, not agents of the corporation). *See also* Bratton & Sepe, *supra* note 34; Heaton, *supra* note 8.

58. Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107 (2003); Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009).

59. Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325 (2013) ("since the mid-2000s…management has responded to shareholder demands as never before." at 1361) [hereinafter Klausner, *Factor and Fiction*]. *See also* Simon Deakin, Prabirjit Sarkar & Mathias Siems, *Is There a Relationship Between Shareholder Protection and Stock Market Development?*, 3 J. L. FIN. ACCT. 115 (2018) ("without exception, all countries have increased the level of shareholder protection" at 124); PAVLOS MASOUROS ET AL., CORPORATE LAW AND ECONOMIC STAGNATION: HOW SHAREHOLDER VALUE AND SHORT-TERMISM CONTRIBUTE TO THE DECLINE OF THE WESTERN ECONOMICS 215-22 (2012) (the "natural" trend of developed nations "is persistently moving towards shareholder empowerment.") Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987 (2010) (CEOs are so constrained by shareholders they can be described as "embattled"); Lipton, "Shareholder Primacy," *supra* note 52, at 874-75; Vicente Cunat, Yiqing Lu & Hong Wu, *Managerial Response to Shareholder Empowerment: Evidence from Majority Voting Legislation Changes* n 2 (Eur. Corp. Governance Inst., Finance Working Paper No. 622, 2019); Bratton & Sepe, *supra* note 34, at n. 38.

have concluded that empirical research is unable to tell us much about the merits of various corporate governance initiatives.[60] As we will see, however, in many areas the general thrust of the literature is quite clear by now. Where possible, we will rely on meta-studies and literature reviews that draw their conclusions from many different studies. Again, we will see that these surveys tend to produce fairly clear—and consistent—outcomes.

Where meta-studies are unavailable, usually because the body of research is comparatively new, we will look at the most recent research, evaluating the ways it differs from earlier studies with different findings. For example, one of the earliest papers discussing the long-term value impact of activist shareholders found it to be positive.[61] The methods employed by this paper were strongly criticized by multiple authors. Subsequent research that improved on its methods comes to different results.[62] There seems no reason to refer to the empirical results in this area as "mixed;" we can confidently rely on the most recent research as reflecting the current best understanding. We will also confine our investigation to studies performed in the United States (and to a much lesser extent, Canada and the U.K.). The legal, cultural, and economic environments of other countries are too different to feel confident treating them the same will tell us something useful. Fortunately, the vast majority of research on these topics utilizes American data.

There are two other aspects of the method we will be using that may provide us with confidence concerning this Article's conclusions. The first is that we are looking at the research on many different aspects of the major hypotheses generated from agency cost theory. To take one example, we are testing the hypothesis that increasing shareholder power relative to mangers improves corporate outcomes by reducing agency costs. To test this hypothesis, we are not looking at a single body of research. Instead, we are examining the literatures on the rise of institutional investors, the valuation of voting rights, the rationale and outcomes of shareholder voting, the results from the introduction of majority voting, the results produced by proxy contests, the effect of dual-class share structures, the nature of shareholder proposals, and the impact of say-on-pay votes. It is possible that we might miss crucial research in one or two areas, or

60. Michael Klausner, Empirical Studies of Corporate Law and Governance: Some Steps Forward and Some Steps Not, (Eur. Corp. Governance Inst. Law Working Paper No. 381, 2018), https://ecgi.global/sites/default/files/working_papers/documents/finalklausner.pdf; Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 U. IOWA J. CORP. L. 637 (2006). *See, e.g.*, Stephen Bainbridge, *Stephen Bainbridge disdains the trend towards empirical legal scholarship*, PROFESSOR BAINBRIDGE (Feb. 28, 2011), https://www.professorbainbridge.com/professorbainbridgecom/2011/02/ucla-law-professor-stephen-bainbridge-disdains-the-trend-towards-empirical-legal-scholarship.html. *But see* Brett McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of New Corporate Governance in Theory and Practice*, 34 DEL. J. CORP. L. 139, 187 (2009).

61. Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1101 – 1120 (2015).

62. *See* discussion *infra* notes 114-118.

that the body of research in an area may be consistently making mistakes in the way they measure the relevant variables. But, the hope is that by surveying many different bodies of research, these sorts of errors will not impact the paper's overall conclusions.

The second support for this paper's method is that its thesis is relatively modest. It is proposing that agency cost theory's normative program has consistently failed to generate positive corporate outcomes. It is not claiming that agency cost theory has generated *negative* corporate outcomes (although this could be argued, at least in certain areas). Even if the empirical evidence is "mixed," this should be fatal to agency cost theory. To serve a useful function in guiding legal understandings, regulatory reform, and corporate behavior, agency cost theory should produce clear, positive results. There are costs to the many regulatory and governance practices we have introduced over the past forty years; those costs are too high even if the benefits are "murky."[63]

Let's take the example of the earliest paper on the long-term effects of shareholder activism discussed above. Even if that paper did not suffer from methodological flaws, the actual long-term results it found from shareholder activism were tiny. Under one measure, the returns were, in fact, negative. Under a different measure that generated positive abnormal stock price returns, the size of this return was, in the words of one set of scholars, "infinitesimal."[64] If agency cost theory is going to be used to justify regulatory reforms and interfering in market processes, it should produce more clearly beneficial outcomes than this.

A. Hypothesis 1: Increasing Shareholder Power Over Managers Will Lead to Better Corporate Outcomes

The idea that managers are misdirecting corporate cashflows to advance their personal interests is probably the most obvious conclusion that was drawn from the initial literature on agency costs.[65] It seems uncontroversial that increasing the power of the principal to monitor and control the actions of the agent would have the effect of reducing the residual loss, which has always been assumed to be large.[66] Stock exchanges, securities regulators, corporate governance codes,

63. *See, e.g.*, James S. Linck, J.M. Netter & T. Yang, *The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors*, 22 REV. FIN. STUD. 3287, 3289 (2009); Steven Boivie, M.K. Bednar & S.B. Barker, *Social Comparison and Reciprocity in Director Compensation*, 41 J. MGMT. 1578, 1579 (2015) (noting director pay has increased to the point that "corporate directors . . . [are] classified in the top 3% of all wage earners in the country, from their board compensation alone").

64. Yvan Allaire & François Dauphin, *Activist Hedge Funds: Creators of Lasting Wealth? What Do the Empirical Studies Really Say?*, IGOPP (July 17, 2014) at 9, https://igopp.org/wp-content/uploads/2014/07/IGOPP_Article_Template2014_Activism_EN_v6.pdf [hereinafter Allaire & Dauphin, *Creators of Lasting Wealth*].

65. Goshen & Squire, *supra* note 41, at 811.

66. Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006) (arguing shareholders bear significant costs when firms go public with governance structures that entrench management).

and the various third parties that make up the governance industry have all duly thrown their support to initiatives that increase shareholder power relative to management.[67] This, in turn, has generated a great deal of activity that can be used to evaluate the hypothesis.

1. Institutional Shareholders

The early 1990s was a time of considerable enthusiasm regarding the rise of institutional shareholdings in public markets. Law review articles appeared with titles like "The Value of Institutional Investor Monitoring,"[68] "Agents Watching Agents: The Promise of Institutional Investor Voice,"[69] and "The Case for Increasing Shareholder Power."[70] For those looking at the growth of investment fund holdings from the perspective of agency cost theory, it seemed obvious that highly-educated and experienced fund managers would prove superior corporate monitors compared to the retail investors they were replacing.[71] The much larger shareholdings managed by these professionals would provide them with greater incentives to actively engage with firms to reduce agency costs while, at the same time, providing them with greater power over corporate boards.[72]

While there were some initial papers[73] that seemed to suggest that institutional share ownership was connected with superior corporate outcomes,

67. Douglas Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. LAW. 1461 (1992). Other examples are provided by: Directors' Remuneration Report Regulations 2002 (DRR 2002) and Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111- 203, §951, 124 Stat. 1376, 1899 (2010) (introducing "say-on-pay in the UK and US respectively); The 1988 guidance from the U.S. Department of Labor, that "the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies"): Letter from Pension & Welfare Benefits Administration to Haluth Fandl, Chair of the Retirement Board, Avon Products, Inc. 1988 WL 897696 (Feb. 23, 1988); and the SEC following suit in 2003 in relation to mutual funds, defined contribution plans and similar institutional investors: Proxy Voting by Investment Advisers, Investment Advisors Act Release No. 2106 (Jan. 31, 2003); 17 C.F.R. Part 275.206(4)-6.

68. Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 U.C.L.A. L. REV. 895 (1992) [hereinafter Black, *Institutional Monitoring*].

69. Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 U.C.L.A. L. REV. 811 (1992) [hereinafter Black, *Agents Watching Agents*].

70. Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 833-914 (2005) [hereinafter Bebchuk, *Increasing Shareholder Power*]. See also Bernard S. Black, *Institutional Investors and Corporate Governance: The Case for Institutional Voice*, 5 J. APPLIED CORP. FIN. 19 (1992) [hereinafter Black, *Institutional Voice*]; Mark Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

71. *See* Judith Chevalier & Glenn Ellison, *Are Some Mutual Fund Managers Better than Others?*, 54 J. FIN. 875 (1999); Nicole M. Boyson, The Impact of Hedge Fund Managers' Career Concerns on their Returns, Risk-Taking Behavior, and Performance Persistence (PHD Thesis, Ohio State University, 2003) [unpublished]. *But see* Paul A. Gompers & Andrew Metrick, *Institutional Investors and Equity Prices*, 116 Q. J. ECON. 229 (2001) [hereinafter Gompers & Metrick, *Institutional Investors*] (finding no evidence for the claim institutional investors are "smarter" than other types of investors).

72. Martin Geoffrey, Robert Wiseman & Luis Gomez-Mejia, *The Interactive Effect of Monitoring and Incentive Alignment on Agency Costs*, 45 J. MGMT. 701 (2019); Brian K. Boyd & Angelo M. Solarino, *Ownership of Corporations: A Review, Synthesis, and Research Agenda*, 42 J. MGMT. 1282 (2016).

73. *See, e.g.*, Jeffrey MacIntosh, *Institutional Shareholders and Corporate Governance in Canada*, 26 CAN. BUS. L.J. 145, 179 (1996). *See also* Black, *Institutional Monitoring*, *supra* note 68; Black, *Agents Watching Agents*, *supra* note 69; Bebchuk, *Increasing Shareholder Power*, *supra* note 70, at 913-14;

contrary evidence eventually accumulated to the point where most observers have concluded this is not true. Two meta-studies published in this century, canvassing nearly all of the research on this topic, both found that there is no positive relationship between institutional ownership of a firm's securities and that firm's financial performance, measured either by market returns or accounting measures of performance.[74]

This is not to say, of course, that different kinds of institutional shareholders don't have differing impacts on firm governance. For example, several studies have found long-term investors with low portfolio turnover are associated with longer-term firm strategies measured by R&D expenditures and capital investments.[75] Rather, the point is that agency cost theory's straightforward prediction that stronger shareholders would lead to better outcomes proved to be false. A literature review on this point concludes, "the extensive literature examining relationships between equity ownership and firm financial performance yields little support for the mitigation of the fundamental agency problem."[76]

2. Shareholder Voting

Shareholders' supervision of their agents starts with their voting power. Indeed, Chancellor Strine argues that no changes made to the character of the corporate fiduciary duty will be sufficient to displace shareholders from their preferred position, so long as shareholders retain the franchise[77] (with at least three different types of empirical studies vindicating Strine's view.[78]) Unsurprisingly, therefore, agency cost theory has historically been understood to support extensions of shareholder voting power.[79] This attitude is perfectly

Black, *Institutional Voice*, *supra* note 70; Roe, *Political Theory*, *supra* note 70). Gompers & Metrick, *Institutional Investors*, *supra* note 71.

74. Dan R. Dalton et al., *Meta-Analyses of Financial Performance and Equity: Fusion or Confusion?*, 46 ACAD. MGMT. J. 13 (2003) [hereinafter Dalton et al., *Fusion or Confusion*]; Chamu Sundaramurthy, Dawna L. Rhoades & Paula L. Rechner, *A Meta-Analysis of the Effects of Executive and Institutional Ownership on Firm Performance*, 17 J. MANAGERIAL ISSUES 494 (2005).

75. Brian J. Bushee, *The Influence of Institutional Investors on Myopic R&D Investment Behavior*, 73 ACCT. REV. 305 (1998); Robert E. Hoskisson et al., *Conflicting Voices: The Effects of Ownership Heterogeneity and Internal Governance on Corporate Innovation Strategies*, 45 ACAD. MGMT. J. 697 (2002); Yueting Li et al., *Distracted Institutional Shareholders and Managerial Myopia: Evidence from R&D Expenses*, 29 FIN. RSCH. LETTERS 30 (2019).

76. Dalton et al., *Fundamental Agency Problem*, *supra* note 15, at 23.

77. Leo E. Strine, *Corporate Power is Corporate Purpose I: Evidence from my Hometown*, SSRN (2016) https://papers.ssrn. com/sol3/papers.cfm?abstract_id=2906875.

78. Bryce C. Tingle & Eldon Spackman, *Do Corporate Fiduciary Duties Matter?*, 4 ANN. CORP. GOV. 272 (2014) [hereinafter Tingle & Spackman, *Do Fiduciary Duties Matter*]. *See also* the discussion *infra* notes 291-303.

79. Bebchuk, *Increasing Shareholder Power*, *supra* note 70, at 836; Yonca Ermitur, Fabrizio Ferri & David Oesch, *Does the Director Election System Matter? Evidence from Majority Voting*, 20 REV. ACCT. STUD. 1, 11 (2015); Goshen & Squire, *supra* note 41; Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 897-88 (2013).

summed up by the confident statement by securities regulators that "institutional investors are increasingly engaged in advancing good corporate governance in companies, and one of the ways by which they do so is the exercise of their voting rights."[80]

While agency cost theory leads us to expect evidence shareholders regard their voting power over managers as a powerful disciplining force, the available evidence suggests otherwise.[81] In a typical year, out of the 31,000 American directors up for election, only eight failed to receive a majority of votes.[82] Various attempts at measuring the cash value investors give voting rights find these rights are judged as either worthless or nearly worthless by the market.[83]

When votes are cast, multiple studies have found that they do not appear to have much to do with the relative financial performance of the corporation.[84] Instead, withhold votes against directors appear to primarily arise as a consequence of that director or company failing to adopt certain corporate governance best practices: director independence, regular meeting attendance, "overboarding," non-conforming executive pay, ignoring a successful shareholder proposal, and adopting a poison pill.[85] As we will see, there is no evidence these sorts of best practices are correlated with positive financial firm

80. CSA Notice and Request for Comment–Proposed National Policy 25-201 Guidance for Proxy Advisory Firms, OSC NP, (2014) 37 OSCB 4339, 4339. The SEC's shares this assumption in recent guidance: Securities and Exchange Commission, *Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers*, SEC (Sept. 10, 2019), https://www.sec.gov/rules/interp/2019/ia-5325.pdf. Voting is assumed to often be in the best interests of the beneficial holders of securities and the fiduciary duty generally requires asset managers to vote, unless the costs clearly outweigh the benefits and the beneficial holders agree the asset manager may refrain from voting.

81. Bryce C. Tingle, *Expressive Voting and Irrational Outcomes in Corporate Elections*, (forthcoming) (one file with author) [hereinafter Tingle, *Expressive Voting*].

82. Lisa Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259 (2009). *See also* Paul E. Fischer et al., *Investor Perceptions of Board Performance: Evidence from Uncontested Director Elections*, 48 J. ACCT. ECON. 172 (2009).

83. Luigi Zingales, *What Determines the Value of Corporate Votes?*, 110 Q .J. ECON. 1047 (1995) (finding the premiums for voting stock in America are low and often indistinguishable from zero, except where control of the company is up for grabs); Susan E. K. Christoffersen et al., *Vote Trading and Information Aggregation*, 62 J. FIN. 2897 (2007) (finding no premium for borrowing shares around the relevant dates for shareholder voting); Avner Kalay & Shagun Pant, *The Market Value of the Vote: A Contingent Claims Approach*, SSRN (1 January 2009) https://ssrn.com/abstract=1296269 (finding the market gives very little value to voting rights through comparing prices for shares with the prices for options and bonds that replicate the economic returns of the shares); Oguzhan Karakas, *Another Option for Determining the Value of Corporate Votes*, SSRN (12 October 2009) https://ssrn.com/abstract=1364052 (using a similar "contingent claims" approach as the previous paper, the researchers find voting rights are given very little value by the market).

84. Jie Cai, Jacqueline L. Garner & Ralph A. Walkling, *Electing Directors*, 64 J. CORP. FIN. 2389, 2399, 2416-2417 (2009) (finding no significant relationship between stock returns and voting outcomes) [hereinafter Cai, Garner & Walkling, *Electing Directors*]; Randall S. Thomas & Patrick C. Tricker, *Shareholder Voting in Proxy Contests for Corporate Control, Uncontested Director Elections and Management Proposals: A Review of the Empirical Literature*, 70 OKLA. L. REV. 9 (2017) ("[c]ompany performance has only a limited impact on the outcome of a director election, with results ranging from a statistically but not economically significant relationship to no relationship at all" at 70).

85. Ermitur, Ferri & Oesch, *supra* note 79, at 3401; *see also* Cai, Garner & Walkling, "Electing Directors", *supra* note 84, at 2417 (finding similar concerns behind abnormally low "for" votes).

outcomes. Unsurprisingly, when the firm responds to an abnormally high withhold vote by fixing the offensive corporate governance practice, researchers find no difference in their subsequent operating and stock performance.[86]

If traditional voting behavior does not appear to improve operating results, perhaps majority voting is the solution. Majority voting has grown in popularity over the past decade by expressly appealing to the agency cost assumption that increasing principals' powers over agents leads to more efficient outcomes.[87] Strangely, however, empirical studies show that directors of companies with majority voting policies are *less* likely to be the subjects of withhold votes.[88] The difference is significant: a director of a company without majority voting is nineteen times more likely to lose a vote.[89] The moment shareholders gain power over corporate managers, they become less likely to use it. Similarly, companies with majority voting policies see a slight decline in the total number of shares voted in director elections.[90]

There is limited empirical evidence regarding the financial impact of majority voting on firms. Two event studies studying American firms adopting majority voting policies found no statistically significant price movements; a third found a small abnormal positive return.[91] The only long-term study followed firms over a single year and found majority voting was associated with worse firm performance compared to that of matched companies without majority voting.[92]

In summary, empirical results appear to suggest that shareholders do not regard voting power as valuable and it is not deployed in the way we would expect from an agency cost theory perspective. Voting outcomes do not generally appear to be driven by financial performance or, in other words, by agency costs.

86. Ermitur, Ferri & Oesch, *supra* note 79, at 3402; Diane Del Guercio et al., *Do Boards Pay Attention When Institutional Investor Activists 'Just Vote No'*, 90 J. FIN. ECON. 84 (2008) (finding activist voting "campaign categories that tend to be more about corporate governance practices than firm-specific performance experience no measurable improvement in operating performance" at 93).

87. Lucian A. Bebchuk, *The Myth of Shareholder Franchising*, 93 VA. L. REV. 675, 702 (2007); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 427 (1983) (concluding that "the common law rules of shareholders' voting can, in the main, be analyzed as attempts to reduce agency costs"); Bo Becker & Guhan Subramanian, *Improving Director Elections*, (2013) 3 HARV. BUS. L. REV. 1 (2013).

88. Stephen J. Choi et al., *Does Majority Voting Improve Board Accountability*, 83 U. CHI. L. REV. 1119 (2016).

89. *Id*. at 1122.

90. Jie Cai, Jacqueline L. Garner & Ralph A. Walkling, A Paper Tiger? An Empirical Analysis of Majority Voting, 21 J. CORP. FIN. 119 (2013) [hereinafter Cai, *Paper Tiger*].

91. William K. Jr Sjostrom & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 6-17 (2007) (no positive abnormal return around an announcement); Cai, "Paper Tiger", *supra* note 90, at 129 (no positive return around an announcement); Yonca Ertimur, Fabrizio Ferri & David Oesch, *Does the Director Election System Matter? Evidence from Majority Voting*, 20 REV. ACCT. STUD. 1 (2015) (finding a small positive abnormal return around the relevant announcements).

92. Cai, *Paper Tiger*, *supra* note 90.

3. Shareholder Proposals

A step beyond shareholder voting is the shareholder power to make proposals that can influence the firm's operations if accepted by a majority of shareholders. Analysis of shareholder proposals through the lens of agency cost theory has resulted in a widespread assumption that proposals are a valuable method of constraining corporate agents' discretion.[93]

However, the reality is that shareholder proposals have little impact on the operation of companies. As Professors Kahan and Rock note, proposals tend to be merely symbolic.[94] Shareholders advance proposals requesting management to retract existing poison pills, but they refrain from asking for charter amendments that would prevent managers from reintroducing a poison pill in the face of a hostile bid, when it actually matters.[95] Shareholders refrain from making effective proposals on proxy access (once Delaware gave shareholders the power to impose this) and they avoid mandatory—as opposed to precatory—proposals.[96]

Funds most focused on the financial performance of companies generate virtually none of the shareholder proposals in a given year.[97] Approximately 40 per cent of proposals relate to social issues, the rest mostly request the adoption of some corporate governance structure.[98] These latter proposals tend to reflect the latest governance fad and rarely show any evidence that the proposal reflects the peculiarities of the targeted company.[99] In most years, fewer than 20 per cent of proposals put to the vote attract majority support from other investors.[100]

93. *See, e.g.*, Bebchuk, *Increasing Shareholder Power*, *supra* note 70; Sarah C. Haan, *Shareholder Proposal Settlements and the Private Ordering of Public Elections*, 126 YALE L.J. 262 (2016).

94. Marcel Kahan & Edward Rock, *Symbolic Corporate Governance Politics*, 94 B.U. L. REV. 1997, 1999-2001 (2014).

95. *Id.* at 2002-2014.

96. *Id*.

97. Nickolay Gantchev & Mariassunta Giannetti, *The Costs and Benefits of Shareholder Democracy: Gadflies and Low-Cost Activism* 12-13 (Eur. Corp. Governance Inst., Finance Working Paper No. 586, 2018), www.ecgi.global/sites/default/files/working_ papers/documents/finalgantchevgiannetti.pdf [hereinafter Gantchev & Gianetti, *Shareholder Democracy*]; RONALD J. GILSON & JEFFREY N. GORDON, AGENCY CAPITALISM: FURTHER IMPLICATIONS OF EQUITY INTERMEDIATION, RESEARCH HANDBOOK ON SHAREHOLDER POWER 45 (2015); Gilson & Gordon, *Agency Capitalism*, *supra* note 50, at 887-88; Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. REG. 174, 231 (2001).

98. James R. Copland & Margaret M. O'Keefe, *Proxy Monitor Report: A Report on Corporate Governance and Shareholder Activism* 2 (2016), http://www.proxymonitor.org/Forms/pmr_13.aspx (In 2016, half of all proposals included social or policy concerns. "The 50% of shareholder proposals involving social or policy issues is up from 42% in 2015 and 39% in the broader 2006 -15 period").

99. Gantchev & Giannetti, *Shareholder Democracy*, *supra* note 97, at 37-38, tab 5, ("In fact, between 2003 and 2014, proposals that appeared "generic" (45 per cent), "unfocused" (76 per cent), or "faddish" (30 per cent) made up the vast majority of proposals received by firms in the Standard & Poor's 1500 index.).

100. Sullivan & Cromwell LLP, *2013 Proxy Season Review* 6 (July 2, 2013) (reporting 46/358, 12.85%); Eugene F. Soltes et al., *What Else Do Shareholders Want? Shareholder Proposals Contested by Firm Management* 25 (2017) (unpublished) https://ssrn.com/abstract=2771114 (reports 18.7% contested proposals); James R. Copland & Margaret M. O'Keefe, *Proxy Season Preview: Shareholder Activism en*

Far from being a useful tool for reducing agency costs, shareholder proposals are not aimed at poorly performing firms which merit intervention, but at significantly larger companies which garner more attention.[101] It should not be surprising, therefore, that proposals generate zero or negative returns around the meeting date.[102] A review of 17 long-run share price studies concluded shareholder proposals are not associated with significant long-run returns.[103] A similar conclusion can be drawn from studies looking at operational metrics. "Most evidence . . . indicates that shareholder proposals and direct negotiations are not associated with increases in the target firms' operating performance."[104]

In terms of non-economic outcomes, there have been three different studies that each found that companies targeted by proposals do not change their CEOs at higher rates.[105] This is yet more evidence that agency cost concerns do not explain how shareholders use the proposal mechanism.

4. Proxy Fights (Shareholder Activism)

Shareholder activism is the most dramatic way in which shareholders intervene in the management of a company. Activist campaigns result in shareholders being presented with both a real choice for the election of directors, and considerably more information about the relative merits of the various

Marche (2017), http://www.proxymonitor.org/Forms/pmr_14.aspx ("[i]n 2016, 7% of shareholder proposals received majority shareholder support, down from 11% in 2015 but up from 4% in 2014").

101. Paul Washington & Merel Spierings, *2023 Proxy Season: More Proposals, Lower Support*, Harvard Law School Forum on Corporate Governance (Jun. 1, 2023), https://corpgov.law.harvard.edu/2023/06/01/2023-proxy-season-more-proposals-lower-support/ ("shareholders are continuing to focus on companies where they can get the most attention, not necessarily the companies that may merit the most attention"). *See also*, Ermitur, Ferri & Oesch, *supra* note 79, at 20; Jonathan Karpoff, The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings SSRN (2006) (unpublished) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=885365 (reviewing the literature and concluding, "these results suggest that activists tend to target firms in poorly performing industries, although not the necessarily the worst performing firms in those industries" at 24).

102. Matthew Denes, Joao Dos Santos & Chen Song, *Analysis of the Wealth Effects of Shareholder Proposals – Vol. II,* US Chamber of Commerce (2009) https://www.uschamber.com/assets/archived/images/documents/files/analysis_wealth_effects_volume2.pdf at 10; Cai, Garner & Walkling, *Electing Directors*, *supra* note 84, at 2417 (finding similar concerns behind abnormally low "for" votes.); Matthew Denes, Jonathan M. Karpoff & Victoria B. McWilliams, *Thirty Years of Shareholder Activism: A Survey of Empirical Research*, 44 J. CORP. FIN. 405, 408; Jonathan Karpoff, Paul Malatesta & Ralph Walkling, Corporate Governance and Shareholder Initiatives: Empirical Evidence, 42 J. FIN. ECON 365 (1996) ("the average effect of shareholder corporate governance proposals on stock values is close to, and not significantly different from, zero" at 392).

103. Tingle, *Can We Measure It*, *supra* note 13, at 302-306.

104. Diane Del Guercio & Jennifer Hawkins, *The Motivation and Impact of Pension Fund Activism,* 52 J. FIN. ECON. 293 *(1999);* Johnathan M. Karpoff, Paul H. Malatesta & Ralph A. Walkling, *Corporate Governance and Shareholder Initiatives: Empirical Evidence*, 42 J. FIN. ECON. 365 (1996); Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS,* 51 J. FIN. 227 (1996).

105. *Id. See also* Paul H. Edelman, Randall S. Thomas & Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359 (2014).

candidates. It is widely assumed that these proxy contests are an important disciplinary mechanism for controlling agency costs.[106]

Looking directly at the idea that shareholder activists target companies that are misallocating their free cash flow—including diverting some of that cash flow to insiders—scholars found, after a review of the literature on this issue, that "the majority [of the empirical studies] do not report evidence of changes in real variables consistent with this free cash flow hypothesis."[107]

There is very little evidence that direct shareholder input in corporate decisions generally improves performance. Proxy contests that result in dissident nominees winning places on the board tend to experience significant subsequent underperformance unless they are sold.[108] Operationally, companies that experience a successful activist-led change of management tend to reduce investment in capital assets and R&D spending, reduce the cash in the company, increase their leverage, and fire (or stop hiring) employees.[109] The money made available by these stratagems is distributed to the shareholders.[110] The only study to carefully match activist-controlled firms with targeted firms found no

106. Ronald Gilson & Jeffrey Gordon, *The Rise of Agency Capitalism and the Role of Shareholder Activists in Making it Work*, 31 J. APPLIED CORP. FIN. 1 (2019) [hereinafter Gilson & Gordon, *The Rise of Agency*].

107. John C. Coffee & Darius Palia, *Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 583 (2016).

108. Ed deHaan, David Larcker & Charles McClure, *Long-Term Economic Consequences of Hedge Fund Activist Interventions*, 24 REV. ACCT. STUD. 536, 542 (2019); Allaire & Dauphin, *Creators of Lasting Wealth*, *supra* note 64; Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 362-75 (2009); William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375 (2007); Jonathan Macey & Elaine Buckberg, *Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation,* NERA (2009), (arguing that there are "several studies [that] establish that when dissident directors win board seats, those firms underperform peers by 19% to 40% over the two years following the proxy contest" at 12).

109. *See* Ian D. Gow, Sa-Pyung Sean Shin & Suraj Srinivasan, *Activist Directors: Determinants and Consequences* REV. ACCT. STUD. (2023); Caroline Zhu, *The Preventive Effect of Hedge Fund Activism*, SSRN (2013) (unpublished) https://ssrn.com/abstract=2369533; Alon Brav, Wei Jiang & Hyunseob Kim, *The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes*, 28 REV. FIN. STUD. 2723 (2015) (finding for example that plants of targeted firms are more likely to be sold); Alon Brav et al., *Shareholder Power and Corporate Innovation: Evidence From Hedge Fund Activism*, AEAWEB (December 2014), https://www.aeaweb.org/conference/2015/retrieve.php?pdfid=357 (finding R&D expenditures decline but proxies for innovative activity increase); Coffee & Palia, *Wolf at the Door*, *supra* note 107, at 591 (reviewing the literature and concluding, "activist interventions are 'investment limiting' in that they increase leverage and shareholder payout, while reducing R&D and long-term investment."), 589-90 (noting the evidence in Bebchuk et al, for declines in R&D and long-term investment); Martijn Cremers, Saura Masconale & Simone M. Sepe, *Short-Term Investors, Long-Term Investments, and Firm Value*, ECGI GLOBAL (March 2017), https://ecgi.global/sites/default/files/2._short-term_investors_2._long-term_investments_and_firm_value.pdf; Yvan Allaire & François Dauphin, *The Game of Activist Hedge Funds: Cui Bono?*, 13 INT'L J. DISC. GOV. 279, 293-94 (2016). *See also* Denes, Karpoff & McWilliams, *supra* note 102, at 412, panel tab 2 (2017) (setting out the results of prior research on capital expenditures, payouts to shareholders, asset divestitures, restructurings and layoffs).

110. Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1771 (2008) [hereinafter Brav et al., *Hedge Fund Activism*]; Denes, Karpoff & McWilliams, *supra* note 102, 412, panel B tab 2 showing of seven studies, six found an increase in payout of earnings).

evidence that these maneuvers improved return on assets or return on equity.[111] A recent study looked at "a more comprehensive set of accounting-performance measures including . . . profit margin, asset turnover, and spread over borrowing costs, but again fail to find consistent evidence of improvements following activist interventions."[112] Three recent studies all failed to find shareholder activism results in improvements in business cash flows.[113] These results come as no surprise to investment bank analysts who do not predict post-activism improvements in their corporate earnings forecasts.[114]

There is thus no evidence shareholder activism results in better corporate performance nor meaningful changes to the internal cash flows that are the particular focus of agency cost theory. The share price of companies targeted by activists does increase around the time of the 13D announcement.[115] Unhelpfully, stock prices tend to rise in response to *all* 13D announcements, and the magnitude of the rise when activists announce their presence is not materially different from the rise following 13D announcements from insiders, buy-and-hold financial institutions, 10 per cent holders, as well as others.[116]

When we look at the long-term performance of market price, a well-known early paper found a minor 5.81 per cent improvement in abnormal stock price returns after five years.[117] This paper suffered from several methodological problems. The most significant was a failure to carefully match the firms targeted by activists with control firms, which is essential if you are going to measure the

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111. deHaan et al., *supra* note 108, at 5. *See also* Coffee & Palia, *Wolf at the Door*, *supra* note 107, at 591. Similar results arise from looking at other operational metrics. After reviewing the evidence, professors Coffee and Palia conclude, "[l]ittle evidence supports the thesis that hedge funds promote growth in sales or asset size." *See also* Bryce C. Tingle, *Two Stories About Shareholders*, 58 OSGOODE HALL L.J. 1 57, 90-94 (2021) for an analysis of the flaws in the earlier studies in this area [hereinafter Tingle, *Two Stories*].

112. deHaan et al., *supra* note 108, at 5.

113. These studies are notable for the efforts their authors put into matching activist targets with appropriate controls: April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors,* 64 J. FIN. 187, 201 (2009); Christopher P Clifford, *Value Creation or Value Destruction? Hedge Funds as Shareholder Activists* 14 J. CORP. FIN. 323, 330-31 (2008); Nicole Boyson & Robert Mooradian, *Corporate Governance and Hedge Fund Activism*, 14 REV. DERIVATIVES RSCH. 169, 191 (2011).

114. *Id*.

115. Brav et al., *Hedge Fund Activism*, *supra* note 110, at 1729-75 (average abnormal monthly return of 5.10% for 1,059 targetings of 882 unique firms, by 236 different hedge fund activists); Klein & Zur, *supra* note 113 (reports a 5.7% abnormal return during a 36-day period surrounding the filing dates for 134 targeted firms); Christopher P. Clifford & Laura Lindsey, *Blockholder Heterogeneity, CEO Compensation, and Firm Performance*, 51 J. FIN. & QUANTITATIVE ANALYSIS 1491 (2016). *See also* Marco Brecht et al., *The Returns to Hedge Fund Activism: An International Study*, 30 REV. FIN. STUD. 2933 (2017).

116. Ulf von Lilienfeld-Toal & Jan Schnitzler, *What is Special about Hedge Fund Activism: Evidence from 13D Filings*, 38 (Swedish House of Finance Research, Paper No. 14-16, 2019) https://ssrn.com/abstract=2506704.

117. Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015).

impact of shareholder activism.[118] Using the same dataset, but more carefully matching the firms, a recent paper found that "the firm value of the target firms tends to be 5.5% lower than the firm value of the control firms at the end of the fiscal year in which the activist hedge funds start their campaign, and about 9.8% lower three years thereafter."[119]

When positive long-term shareholder returns do follow activists' intervention with management, it appears from multiple studies that this is nearly entirely a function of the companies in question being acquired.[120] It is possible that this is an instance of agency cost theory being vindicated. The premium paid during a takeover to the target company's shareholders may reflect the value to be contributed by superior management following the acquisition. The role of shareholder activists in increasing the probability of such a change of control could demonstrate the importance of shareholder monitoring of their agents. As we will see below, however, the case that the takeover market is an important method of reducing agency costs is weak.[121] For now, all that matters is that there is no other evidence in the literature around shareholder activism that supports the agency cost story. Rather, the evidence suggests agency theory is wrong: activist shareholder involvement in corporate elections tends to be value-reducing in all but the short term.

5. Dual Class Shares

Dual class shares have generally been understood as giving rise to significant agency costs. "[T]he agency costs associated with [controlling minority structure] firms increase very rapidly as the fraction of equity cash-flow rights held by controllers declines."[122] Daniel Fischel observed that, "[t]he cost of dual-

118. deHaan et al., *supra* note 108 (discussing problems with controls); Allaire & Dauphin, *Creators of Lasting Wealth*, *supra* note 64, at 9 (noting the study started with 1,584 companies and ends in year five with only 694 companies with no attempt to track the companies that are dropped.); Coffee & Palia, *Wolf at the Door*, *supra* note 107, at 588 (discussing problems with the study generally); Martijn Cremers et al., *Hedge Fund Activism and Long-Term Firm Value*, YALE LAW SCHOOL (January 2016) at 7, https://law.yale.edu/system/files/area/workshop/leo/leo16_sepe.pdf [hereinafter Cremers et al., *Hedge Fund Activism*].

119. Cremers et al., *Hedge Fund Activism*, *supra* note 118, at 7; *see* Tingle, *Two Stories*, *supra* note 111, at 93-94.

120. deHaan et al., *supra* note 108 ("[N]early all the positive long-term returns to activist interventions are concentrated in firms that are subsequently acquired." at 6); Nicole M. Boyson, Nickolay Gantchev & Anil Shivdasani, *Activism Mergers*, 126 J. FIN. ECON. 54 (2017); Greenwood & Schor, *supra* note 108; Allaire & Dauphin, *Creators of Lasting Wealth*, *supra* note 64, at 25; Brav et al., *Hedge Fund Activism*, *supra* note 110, at 1759; Coffee & Palia, *Wolf at the Door*, *supra* note 107 ("Changes in the expected takeover premium, more than operating improvements, account for most of the stock price gain, both in short-term and long-term studies." at 588).

121. *See* discussion *infra* at notes 227-57.

122. Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights* in CONCENTRATED CORPORATE OWNERSHIP 310-11 (Randal K Morck, ed., 2000). *See also* Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585 (2017); Ronald W Masoulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697 (2009).

class common stock is that the effectiveness of the market for corporate control as a monitoring device is reduced."[123] For that reason, dual class structures have been markedly unpopular with the tribunes of good governance, such as the Council of Institutional Investors, which frequently calls for regulatory bans on the practice.[124]

As far as we can tell from the research, the motivation behind adopting dual class structures is not agents trying to escape oversight from their principals. One study found that the greatest determinant of dual class structures at the time of IPO was the relative importance of the founders' idiosyncratic vision, measured by media coverage.[125] Other studies have found dual class structures to be predicted by the importance of R&D activities for adopting companies and their exposure to longer term growth opportunities.[126] These sorts of findings explain why dual class structures are currently most associated with rapidly growing technology firms.[127]

The evidence about how dual class share structures impact firm behavior is mixed. Firms with dual class shares pay their executives more, make more acquisitions the market regards as value destroying, and make capital expenditures that have lower impacts on shareholder value.[128] These results are usually understood as examples of agents exploiting the power provided by

123. Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. SCH. 119. 140 (1987).

124. Letter from Jeff Mahoney, Gen. Couns. at Couns. of Institutional Invs. to Edward S Knight, Exec. Vice President, Gen. Couns. & Chief Regul. Officer for NASDAQ OMX Grp. 1-2 (Oct. 2, 2012), https://www.cii.org/files/issues_and_advocacy/correspondence/2012/10_02_12_cii_letter_to_nasdaq_dual_class_stock.pdf; Letter from Jeff Mahoney, Gen. Couns. of Institutional Invs. to Claudia Crowley, CEO and Chief Regul. Officer for NYSE Regul. (Oct. 2, 2012), https://www.cii.org/files/issues_and_advocacy/correspondence/2012/10_2_12_cii_letter_to_nyse_dual_class_stock.pdf. Even politicians have gotten into the act: Letter from Elizabeth Warren, U.S. Sen. to John Carey, Vice President-Legal for NYSE Regul. and NYSE Euronext & Edward Knight, Exec. Vice President and Gen. Couns. for NASDAQ OMX (June 5, 2013), http://www.warren.senate.gov/files/documents/Senator%20Warren%20letter%20to%20NYSE,%20Nasdaq%20-%206-5-2013.pdf (explaining that "[t]he number of public companies using multi-class stock structures has risen sharply in recent years, which underlines the urgency of issuing a proposal to generate public comment on the important corporate governance issue.")

125. Adi Grinapell, *Dual-Stock Structure and Firm Innovation*, 25 STAN. J. L. BUS. FIN. 40 (2020); Adi Grinapell, *What Drives the Use of Dual-Class Structures in Technology IPOs?*, (forthcoming).

126. Jordan Bradford, Soohyung Kim & Mark H. Liu, *Growth Opportunities, Short-Term Market Pressure, and Dual-Class Share Structure*, 41 J. CORP. FIN. 304 (2016) (demonstrating that dual-class structures promote risk-taking and R&D spending); Kenneth Lehn, Jeffry Netter & Annette Poulsen, *Consolidating Corporate Control: Dual-Class Recapitalizations Versus Leveraged Buyouts*, 27 J. FIN. ECON. 557 (1990) (showing firms with growth opportunities often convert to dual-class shares); Hyunseob Kim & Roni Michaely, *Sticking Around Too Long? Dynamics of the Benefits of Dual Class Structures* (European Corp. Governance –Inst. Fin. Working Paper No. 590, 2019).

127. Jay Ritter, *Initial Public Offerings: Dual Class Structures of IPOs Through 2020*, (Dec. 29, 2020), https://site.warrington.ufl.edu/ritter/files/IPOs-Dual-Class.pdf. *See generally* Council for Institutional Investors, "Dual-Class IPO Snapshot:2017-2019 Statistics" (last visited May 10, 2021), https://www.cii.org/files/issues_and_advocacy/DualClassStock/Jan%202020%20Dual%20Class%20Update%20for%20Website.pdf. Bobby V. Reddy, *More Than Meets the Eye: Reassessing the Empirical Evidence on US Dual-Class Stock* 7 (Univ. of Cambridge Fac. of Law Rsch. Paper No. 20, 2020).

128. Masoulis, Wang & Xie, *supra* note 122.

unequal voting rights, but they are compatible with another explanation. We have already seen that dual class share structures tend to predominate in innovative companies pursuing idiosyncratic long-term strategies. We expect they would pay the authors of their idiosyncratic strategies more, and make investments the market does not regard as accretive until later.[129] As it happens, it appears that the increase in executive pay does not come in the form of simple cash payouts, which we might expect from the agency cost story. Rather it comes from heavier use of equity incentives with contingent payouts, which have the effect of aligning managerial interests with the shareholders.[130] The only other datapoint about internal behavior is that companies with dual class structures pay more cash out to shareholders than matched firms.[131] This also does not seem like the behavior of agents exploiting their principals' weakness.

Whether the investment and compensation behavior found by these studies reflects managerial self-interest or the corporation's best interest can only be resolved by looking at long-term outcomes. As you would expect, there is a large body of research on this topic, and at first glance it appears to be, at best, inconclusive.[132] Breaking down the methods employed by the various studies, however, reveals more homogeneity in the findings than a casual look would suggest.

In a recent paper, Professor Bobby Reddy notes that the studies on dual class shares can be divided into three categories.[133] First, a large body of research looks at the market valuation of dual-class companies; most of the papers discover it to be lower than matched control groups.[134] This could be the result of

129. One of the authors of the study finding possible agency cost problems makes this argument in a subsequent paper: Suman Banerjee & Ronald W. Masoulis, *Ownership, Investment and Governance: The Costs and Benefits of Dual Class Shares* (Eur. Corp. Governance Inst., Fin. Working Paper No. 352, 2013).

130. Ben Amoaka-Adu, Vishaal Baulkaran & Brian F. Smith, *Executive Compensation in Firms with Concentrated Control: The Impact of Dual Class Structure and Family Management*, 17 J. CORP. FIN. 1580 (2011).

131. *See* Bradford D. Jordan, Mark H. Liu & Qun Wu, *Corporate Payout Policy in Dual-Class Firms*, 26 J. CORP. FIN. 1, 5-6 (2014).

132. *See* Reneée Adams & Daniel Ferreirria, *One Share-One Vote: The Empirical Evidence*, 12 REV. FIN. 51, 63-69 (2008) (suggesting that the best explanation for the various studies in the area is that dual class share structures are beneficial to some firms and harmful to others.)

133. *See* Bobby V. Reddy, *More than Meets the Eye: Reassessing the Empirical Evidence on US Dual-Class Stock*, 23 U. PENN. J. BUS. L. 955, 960-62 (2021).

134. *See generally* Ekkehart Bohmer et al., *The Effect of Consolidated Control on Firm Performance: The Case of Dual Class IPOs*, in Mario Levis, ed, EMPIRICAL ISSUES IN RAISING EQUITY CAPITAL 95, 111 (Mario Levis, ed., 1995); Martijn Cremers, Beni Lauterbach & Anete Pajuste, *The Life-Cycle of Dual Class Firm Evaluation*, (Eur. Corp. Governance Inst., Finance Working Paper No. 550, 2018), https://www.ecgi.global/sites/default/files/The%20Life-Cycle%20of%20Dual%20Class%20Firm%20Valuations-%20Paper.pdf; Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051 (2010); Ronald C. Anderson, Ezgi Ottolenghi & David M. Reed, *The Dual Class Premium: A Family Affair*, (Fox School of Business Research Paper No. 17-021, 2017), https://ssrn.com/abstract=3006669; Scott B. Smart, Ramabhadran S. Thirumalai & Chad J. Zutter, *What's in a Vote? The Short- and Long-Run Impact of Dual-Class Equity on IPO Firm Values*, 45 J. ACCT. ECON. 94 (2008); Ben Amoako-Adu, Vishaal Baulkaran & Briand F. Smith, *Dual Class Discount, and the*

managerial expropriation of value (the agency cost story) or it could be due to the market systematically undervaluing these companies for some reason. The second collection of studies looks at the relative performance of a portfolio of dual-class companies compared to a matched portfolio of non-dual class firms, and finds the dual-class portfolio generates higher returns.[135] If the market valuation of dual class firms was correct, the two portfolios should generate identical returns, so this group of studies suggest the market is, in fact, systematically undervaluing companies with dual-class shares. The third group of studies look at measures of actual operating performance: several find dual class firms display superior operating performance results, none find underperformance.[136] Thus, the picture that emerges is that the market believes the agency cost theory story, but the market is wrong.[137] Managers entrenched by dual class shares are not measurably worse agents, and they may even be superior. Professor Reddy summarizes his analysis, "[t]he better operating performance of dual-class firms is so stark that investors can earn greater returns from portfolios of such stock…even though the market perpetually undervalues the stock."[138]

Channels of Extraction of Private Benefits, 16 ADVANCES FIN. ECON. 165 (2014); Belen Villalonga & Raphael Amit, *How Do Family Ownership, Control and Management Affect Firm Value?*, 80 J. FIN. ECON. 385 (2006); Bradford D. Jordan, Soohyung Kim & Mark H. Liu, *Growth Opportunities, Short-Term Market Pressure and Dual-Class Share Structure*, 41 J. CORP. FIN. 304 (2016); Chun-Keung Hoi & Ashok Robin, *Agency Conflicts, Controlling Owner Proximity, and Firm Value: An Analysis of Dual-Class Firms in the United States*, 18 CORP. GOV. INT'L REV. 124 (2010); Wayne H. Mikkelson & Megan Partch, *The Consequences of Unbundling Managers' Voting Rights and Equity Claims*, 1 J. CORP. FIN. 175 (1994); Kim & Michaely, *supra* note 126, at 5; Thomas J. Chemmanur, Imants Paeglis & Karen Simonyan, *Management Quality and Antitakeover Provisions*, 54 J.L. ECON. 651 (2011) (These studies show a mix between positive, negative and no correlation between firm value and dual class shares).

135. Bohmer et al., *supra* note 134, at 109; Anderson, Ottolenghi & Reed, *supra* note 134, at 23; Valentin Dimitrov & Prem C. Jain, *Recapitalization of One Class of Common Stock into Dual-Class: Growth and Long-Run Stock Returns*, 12 J. CORP. FIN. 342, 347 (2006); Scott Bauguess, Myron B. Slovin & Marie E. Sushka, *Large Shareholder Diversification, Corporate Risk Taking, and the Benefits of Changing to Differential Voting Rights*, 36 J. BANK. FIN. 1244, 1251 (2012); Chemmanur, Paeglis & Simonyan, *supra* note 134, at 681 (dual class share portfolio associated with higher abnormal returns); Mikkelson & Partch, *supra* note 134, at 191(finding lower returns in the first year and positive returns thereafter); Cremers, Lauterbach & Pajuste, *supra* note 134, at 24; Smart, Thirumalai & Zutter, *supra* note 134, at 106 (finding dual class share portfolios associated with no abnormal returns).

136. Onur Arugaslan, Douglas O. Cook & Robert Kierschnick, *On the Decision to Go Public with Dual Class Stock*, 16 J. CORP. FIN. 170 (2010); Cremers, Lauterbach & Pajuste, *supra* note 134; Bohmer et al., *supra* note 134; Kenneth Lehn, Jeffry Netter & Annette Poulson, *Consolidating Corporate Control: Dual-Class Recapitalizations Versus Leveraged Buyouts*, 27 J. FIN. ECON. 557 (1990); Chemmanur, Paeglis & Simonyan, *supra* note 134 (dual class firms demonstrate superior performance by at least one measure); Gabriel Morey, *Multi-Class Stock and Firm Value*, (May 2017), https://www.cii.org/files/publications/misc/05_10_17_dual-class_value_study.pdf; Mikkelson & Partch, *supra* note 134; Smart, Thirumalai & Zutter, *supra* note 134 (no difference between the different types of firms); Kim & Michaely, *supra* note 126; Bauguess, Slovin & Sushka, *supra* note 135; Dimitrov & Jain, *supra* note 135 (finding only certain kinds of dual-class firms outperform).

137. Reddy, *supra* note 127 ("the most plausible interpretation [of all the evidence] is that the market is not efficient, and the market is ideologically predisposed to discount dual-class stock…even though the empirical evidence suggests that, on average, those risks don't play out in practice." at 5).

138. *Id.* at 5.

6. Voting on Executive Compensation

Executive compensation is the most obvious and direct kind of agency cost. From the beginning, agency cost theory was suspicious of managerial power over compensation decisions.[139] In 1980, Eugene Fama noted, that "[h]aving gained control of the board, top management may decide that collusion and expropriation of security holder wealth are better than competition among themselves."[140] It has generally been assumed that increasing shareholder oversight of executive compensation will lead to lower pay packages as the opportunities for self-dealing are reduced.[141] This has been the clear direction of regulation over the past forty years.[142]

On its face, the increasing power of shareholders over compensation decisions appears to have coincided with unprecedented increases in executive

139. Jensen & Meckling, *supra* note 1 (a CEO, as a utility maximizer, will not always act in the best interests of the shareholders and principals generally, including in the context of remuneration); Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them,* (Eur. Corp. Governance Inst. Working Paper No. 44, 2004) ("[w]hile remuneration can be a solution to agency problems, it can also be a source of agency problems" at 50). *See also* Patrice Gelinas & Lisa Baillargeon, *CEO Compensation in Canada, 1971-2008*, 8 Int'l J. BUS. MGMT. 1 (2013) ("[t]he modern history of executive compensation began in parallel with the emergence and acceptance of agency theory" at 1); Martin J. Conyon, *Executive Compensation and Board Governance in US Firms*, 124 ECON. J. FIN. 60 (2014) ("[t]he standard theoretical approach to executive compensation is the principal-agent model" at F63); Dalton et al., *Fundamental Agency Problem*, *supra* note 15 (discussing the use of equity incentives as a method of mitigating agency costs); *see, e.g.*, Fama, *supra* note 14, at 293; Bengt Holmstrom, *Managerial Incentive Problems: A Dynamic Perspective*, 66 REV. ECON. STUD. 169 (1999); Holmstrom, *Moral Hazard*, *supra* note 14, at 74 (discussing principal-agent information asymmetry in the context of labor contracting); Charles Melson, *Executive Overcompensation- A Board-Based Solution*, 34 B.C. L. Rev. 937, 942 (1993) (warning that when it comes to executive compensation, boards have been captured by management); DEREK BOK, THE COST OF TALENT: HOW EXECUTIVES AND PROFESSIONALS ARE PAID AND HOW IT AFFECTS AMERICA 98 (1993) (executives set their own pay and directors have too little information and incentives to properly regulate this process); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983) (examining the use of pay by boards to mitigate agency costs) [hereinafter Fama & Jensen, *Separation*]; GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 221-23 (1991) (discusses the system of self-dealing that produced US corporate remuneration practices); Jensen & Murphy, *Remuneration Fix*, *supra* note 139, at 82 (the structure of executive compensation - particularly pay-for-performance - is important in mitigating agency costs); Sanford J. Grossman & Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 ECONOMETRICA 7 (1983) (discussing optimal incentive schemes to mitigate agency costs).

140. Fama, *supra* note 14, at 293.

141. *See, e.g.*, Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 73 (2003) (Since managers suffer from an agency program and do not seek to maximize shareholder value, they must be adequately incentivized.); Randall S. Thomas & Cristoph Van Der Elst, *Say on Pay Around the World*, 92 WASH. U.L. REV. 653 (2015) (providing a summary of the agency cost explanations for the rise of say on pay).

142. *See, e.g.*, Alex Edmans & Xavier Gabaix, *Executive Compensation: A Modern Primer*, (Nat'l Bureau of Econ. Rsch., Working Paper No 21131, 2015) www.nber.org/papers/w21131 (A recent summary of the finance literature on executive compensation described the process: "This perspective [governance-failure explanations], espoused most prominently by Bebchuk and Fried (2004), has been taken very seriously by both scholars and policymakers, and led to major regulatory changes." at 2); Bryce C. Tingle, *Framed! The Failure of Traditional Agency Cost Explanations for Executive Pay Practices*, 54 ALTA. L. REV. 899, 906-07 (2017) [hereinafter Tingle, *Framed*].

compensation, which has exploded over the period we are considering.[143] In other words, the most readily apparent measure of agency costs has increased at precisely the same time shareholders have been getting more information and authority in this area.

The usual agency cost explanation of managerial self-dealing is not a good explanation for what has occurred over the past three decades.[144] To the extent there is evidence of causality, it suggests shareholders and the tribunes of good governance are to blame for nearly the entire rise in executive compensation.[145] This rise has come from trying to align managers' economic interests with those of the shareholders, as entailed by agency cost theory. Managers have simply been following the best practices (using equity incentives and pay-for-performance structures) recommended to them.[146]

Whatever the merits of those arguments, the impact of shareholders has not had the effect of holding down compensation levels. First, an examination of institutional investors' proxy voting guidelines—which includes the guidelines published by proxy advisors whose work is designed to appeal to their institutional clients—shows that the pay practices most associated with the increase in total compensation levels are the very ones enjoined on companies.[147] Studies show that companies that adopt these pay practices are rewarded by the market, despite the fact that these practices have led to much higher amounts being diverted to managers.[148] This improvement in market value occurs even

143. *See, e.g.*, Carola Frydman & Dirk Jenter, *CEO Compensation*, 2 ANN. REV. FIN ECON. 75, 80 (2010); Thomas Piketty & Emmanuel Saez, *Top Incomes and the Great Recession: Recent Evolutions and Policy Implications*, 61 IMF ECON. REV. 456, 458 (2013); Lawrence Mishel & Natalie Sabadish, *CEO Pay in 2012 Was Extraordinarily High Relative to Typical Workers and Other High Earners*, 367 ECON. POL'Y INST. 1 (2013). Lucian A. Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283, 286-87 (2005); Harwell Wells, *U.S. Executive Compensation in Historical Perspective*, *in* RESEARCH HANDBOOK ON EXECUTIVE PAY 41, 49 (Randall S Thomas & Jennifer G Hill, eds., 2012); Conyon, *Executive Compensation*, *supra* note 139, at F60 (the trend in pay reflects "a real growth rate ..of approximately 4% per annum every year for almost 30 years"); JOSEPH E. STIGLITZ, THE PRICE OF INEQUALITY 25-27 (, 2012); Marc Moore, *Corporate Governance, Pay Equity, and the Limitations of Agency Theory* 7 (Univ. of Cambridge Faculty of Law Working Paper, No. 8, 2015) https:/papers.ssrn.com/sol3/papers.cfm?abstract_id=2566314; Edmans & Gabaix, *supra* note 142, at 4 (in 2013, "CEO pay was 350 times that of the average worker"). Kevin J. Murphy, *Executive Compensation*, *in* 3 HANDBOOK OF LABOR ECONOMICS (Orley C. Ashenfelter & David Card eds., 1999) [hereinafter Murphy, *Executive Compensation*].Hugh Mackenzie, *Glory Days: CEO Pay in Canada Soaring to Pre-Recession Highs*, Canadian Centre for Policy Alternatives (January 2015) at 7-8, https://www.policyalternatives.ca/publications/reports/glory-days (In Canada, statistics are hard to come by prior to 1995, but in 1998 the average CEO of the 100 largest companies in Canada earned 105 times more than the average Canadian; in 2013 he or she earned 195 times more. The top 50 CEOs earned 269.7 times more than the average Canadian).

144. Bryce C. Tingle, *How Good Are Our Best Practices When It Comes to Executive Compensation: A Review of Forty Yes of Skyrocketing Pay, Regulation, and the Forces of Good Governance*, 80 SASK. L. REV. 387 (2017) [hereinafter Tingle, *Best Pay Practices*].

145. Tingle, *Framed*, *supra* note 142.

146. *Id*.

147. *Id.* at 922.

148. Angela G. Morgan & Annette B. Poulsen, *Linking Pay to Performance - Compensation Proposals in the S&P 500*, 62 J. FIN. ECON. 489 (2001); MICHAEL B. DORFF, INDISPENSABLE AND OTHER

where there is no discernable improvement in corporate financial performance.[149]

If we look at private equity compensation practices, where the shareholders have complete control over remuneration decisions, we find their pay practices "statistically indistinguishable" from those of public companies.[150] In fact, executive compensation actually goes up when a company goes private and shareholder authority over managers becomes absolute.[151] Over the past several decades, the pay at closely held firms has outpaced that of public companies.[152]

Turning to say-on-pay votes, we find that companies almost never lose them.[153] In neither the U.S. nor the U.K. is there much evidence that say-on-pay has changed the overall level or growth of executive compensation.[154] Managerial pay in the U.K., which introduced say-on-pay in 2002, actually increased faster than the U.S. over the following decade.[155]

It might be argued that the growth in executive compensation presided over by shareholders—which largely consisted of a change in its composition and risk profile—has actually led to improvements in corporate performance. This argument amounts to saying that, notwithstanding the fact most of the rhetoric around executive compensation from shareholders and corporate governance

MYTHS: WHY THE CEO PAY EXPERIMENT FAILED AND HOW TO FIX IT 128 (2014); Andrew C.W. Lund & Gregg D. Polsky, *The Diminishing Returns of Incentive Pay in Executive Compensation Contracts*, 87 NOTRE DAME L. REV. 677, 689-706 (2011) (detailing the reasons to believe pay-for-performance remuneration schemes' marginal benefit are quite low).

149. Juan P. Sanchez-Ballesta & Emma Garcia- Meca, *A Meta-Analytic Vision of the Effect of Ownership Structure on Firm Performance*, 15 CORP. GOV. 879, 887-88 (2007).

150. Robert J. Jackson Jr., *Private Equity and Executive Compensation*, 60 U.C.L.A. L. REV. 638, 652, 655 (2013).

151. Henrik Cronqvist & Rudiger Fahlenbrach, *CEO Contract Design: How Do Strong Principals Do It?*, 108 J. FIN. ECON. 659, 663 (2013).

152. Steven N. Kaplan, *Executive Compensation and Corporate Governance in the United States: Perceptions, Facts, and Challenges*, 2 CATO PAPERS PUB. POL'Y 99, 102 (2012); Cronqvist & Fahlenbrach, *supra* note 151, at 660.

153. Brian V. Breheny et al., *Say-on Pay Votes and Compensation Disclosures*, Harvard Law School Forum on Corporate Governance (Jan. 6, 2021), https://corpgov.law.harvard.edu/2021/01/06/say-on-pay-votes-and-compensation-disclosures/ (noting 97.7% of the Russell 3000 receive approval); Jeffrey N. Gordon, *'Say On Pay': Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In*, .46. HARV. J. LEGIS. 323, 343 (2009) (noting that since the inception of say-on-pay in2002, British companies lost only 8 votes) [hereinafter Gordon, *Say on Pay*]; Conyon, *Executive Compensation*, *supra* note 139, at F83 (noting that 98 percent of executive pay packages are approved in the US and more than four-fifths of companies had votes in favor in excess of 80 percent).

154. Fabrizio Ferri & David A. Maber, *Say on Pay Votes and CEO Compensation: Evidence from the UK*, .17. REV. FIN. 527, 529 (2013); Martin Conyon & Graham Sadler, *Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK*, 18 CORP. GOV. AN INT'L REV. 296, 297 (2010) (finding little evidence that average CEO pay fell following adverse voting, or that there were large changes in CEO pay structure); Larcker et al., *Ten Myths of 'Say on Pay'*, Stanford Closer Look Series(June 28, 2012), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2094704 (noting one of the myths of say on pay is that it reduces executive compensation levels). *But see* Martin Conyon, *Shareholder Say-on-Pay Voting and CEO Compensation*, (2016)https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2748645 (finding CEO pay at least increases at slower rates in the very few companies that have previously attracted high levels of dissent on say-on-pay votes).

155. Gordon, *Say on Pay*, *supra* note 153, at 344.

actors has been about controlling pay or reducing it, in reality the point has been to shift corporate pay structures in ways that will lead to superior wealth creation for shareholders.[156] But as we will see when considering the agency cost hypotheses around executive incentives, there is little evidence pay changes have done this either.[157]

7. Summary

There is virtually no evidence that shareholder power reduces agency costs. Shareholder behaviors do not appear motivated to accomplish anything in this line, and the ways shareholders do use their power have little impact on the financial performance, behavior, or cash flows of their firms. Where we can see any impact of shareholder influence at all, the effects seem primarily to be negative. Strangely, this means the agents do a better job without the oversight of their principals.[158]

B. Hypothesis 2: A More Independent Board Will Better Monitor Managers, Improving Outcomes

As we have already seen, one of the earliest conclusions drawn from agency cost theory was the important role directors could play in monitoring managers.[159] Indeed, the first regulatory change of the modern era was a change to the New York Stock Exchange's listing rules in 1977, emphasizing the importance of private directors.[160] Since then, North American businesses have gone from boards with a minority of independent directors, through boards with a majority of independent directors, through boards with a super-majority of independent directors, to the point now where best practice is usually understood to consist of a board entirely comprised of independent directors with the CEO

156. Leo E. Strine, *Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, .126. YALE L.J. 1870 (2017). ("top corporate managers have been promised pay packages way out of line with other managers, but in exchange must focus intently on stock price growth and be willing to treat other corporate constituencies callously if that is necessary. . ." at 1872).

157. See discussion *supra* note 184, at 226.

158. Quinn D. Curtis & Justin J. Hopkins, *Career Concerns for Revealing Misreporting*, .438 REV. ACCT. STUD. (2021). (One example of this is the finding that director turnover and withhold votes increased for directors at firms that investigated option-backdating and restated their financial results compared to firms where backdating occurred but which conducted no investigations or restatements).

159. Fama, *supra* note 14 ("But by what mechanism can top management be disciplined? Since the body designated for this function is the board of directors, we can ask how it might be constructed to do its job." at 293); Eisenberg, *Structure*, *supra* note 14; Fama & Jensen, *Separation*, *supra* note 139; Eugene Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J. L. ECON. 327 (1983) [hereinafter Fama & Jensen, *Residual Claims*]; Mark S. Mizruchi, *Who Controls Whom? An Examination of the Relation Between Management and Boards of Directors in Large American Corporations*, 8 ACAD. MGMT. REV. 426 (1983); *see also supra* note 29 and accompanying text.

160. Robert B. Thompson, *Delaware, the Feds, and the Stock Exchange: Challenges to the First State as First in Corporate Law*, 29 DEL. J. CORP. L. 779 (2004); New York Stock Exchange, "New York Stock Exchange Listed Company Manual" (New York, NYSE), paras 303A (1), (2), (4) and (5) at 795-96).

as the lone exception.[161] It is notable that this triumph of the monitoring conception of the board has occurred even while actual sitting directors believe the monitoring role is less important than a board's role in succession planning, strategy, and developing talent within the organization.[162] It has also occurred during a time that the advantages of inside directors, with their superior knowledge, has increased as a result of companies becoming larger, more complex, and more focussed on technical innovation. The move towards independence was even oddly accelerated as a result of the Enron-era scandals, which clearly demonstrated that independent directors were too reliant on senior executives for their information about what was transpiring within the company to provide effective monitoring.[163]

1. Independent Directors

No aspect of corporate governance has been more exhaustively empirically tested than the impact of board independence.[164] The results have been well-known for decades with, surprisingly, no impact on the behavior of institutional shareholders, regulators, proxy advisors, or governance experts.[165] A meta-analysis performed in 1999, making use of 54 earlier studies, found conclusively that there was no connection between board independence and performance.[166] Literature reviews in 2002, 2003, and 2007 came to the same conclusions.[167] Studies since these early surveys of the literature find either no impact or a negative impact on firm value as a result of increasing board independence.[168]

161. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1474 (2007) (From 1950 to 2005, the percentage of independent directors on American corporate boards rose from approximately 35% to 70%); Spencer Stuart, *Spencer Stuart Board Index* 12 (2015) https://www.spencerstuart.com/~/media/pdf%20files/research%20and%20in- sight%20pdfs/ssbi-2015_110215-web.pdf4 (By 2015 that number had climbed to 84%).

162. Robert C. Clark, *Harmony or Dissonance? The Good Governance Ideas of Academics and Worldly Players*, 70 BUS. LAW. 321, 331-32 (2015).

163. Roberta Romano, *Quack Corporate Governance*, 26 CORP. BOARD 5 (2005) [hereinafter Romano, *Quack*]; BETHANY MCLEAN & PETER ELKIND, SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON (2004)

164. Bryce C. Tingle, *What Do We Really Know About Corporate Governance? A Review of the Empirical Research since 2000*, 59 CAN. BUS. L.J. 292, 298 (2017). [Tingle, "Best Practices"].

165. *Id.* at 296-98.

166. Dan R. Dalton et al., *Number of Directors and Financial Performance: A Meta-Analysis*, 42 ACAD. MGMT. J. 674 (1999).

167. Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999); Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, 9 ECON. POL. REV. 7 (2003); Dalton et al., *Fundamental Agency Problem*, *supra* note 15, at 33 (finding that "[t]here is…no evidence to suggest that the independence in the composition of boards of directors is related to corporate financial performance.").

168. *See, e.g.*, Eric Fogel & Andrew M. Geier, *Strangers in the House: Rethinking Sarbanes-Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33, 52 (2007) (A 2007 study of 254 public companies on 50 industries found "the worst ROE [return on equity] performers in each of 50 industries have approximately the same percentage of independent directors as the best ROE performers in each

Complex companies, companies for whom R&D is important, and companies where managing risk is essential appear to be particularly adversely impacted by independent directors.[169]

If we use executive remuneration as the most easily measured manifestation of agency costs, it appears independent directors do not have any impact on this either. A meta-analytic review of research on the question found no evidence independent directors do better at controlling executive pay.[170] The study concluded that its findings provided "little support to agency theory predictions."[171] This should not be unsurprising as the explosive growth in executive pay has largely coincided with the increasing independence of corporate boards.[172] In fact, a number of studies have found that executive pay *increases* under independent directors, likely as a result of the increased use of equity compensation structures.[173] Relatedly, independent boards also do not do any better at identifying and terminating underperforming CEOs than insider-dominated boards.[174]

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industry. No pattern emerges to suggest that it makes any difference at all to shareholders' financial return whether a board has a higher or lower percentage of independent directors."); Sanjai Bhagat & Brian Bolton, *Corporate Governance and Firm Performance*, 14 J. CORP. FIN. 257, 258 (2008) (a 2008 study covering more than 20 years and containing up to 20,000 samples for some of the variables, found "board independence is negatively correlated with contemporaneous and subsequent operating performance."); M. Babajide Wintoki, James S. Linck & Jeffery M. Netter, *Endogeneity and the Dynamics of Internal Corporate Governance*, 105 J. FIN. ECON. 581 (2012) (A 2012 study of 6,000 firms over 22 years and using more sophisticated statistical techniques to measure casual effects, determined there is "no causal relation between board size or independence, and firm performance"). *See also* Sebastien Gay & Chris Denning, *Corporate Governance Principle-Agent Problem: The Equity Cost of Independent Directors* (Oct. 17, 2014) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2468942 (Finding "a majority of independent directors on the board has an overall negative effect on stock returns.").

169. David H. Erkens, Mingyi Hung & Pedro Matos, *Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide*, 18 J. CORP. FIN. 389 (2012) (finding that independent directors were associated with worse outcomes at financial firms during the 2008 crisis); Ran Duchin, John G. Matsusaka & Oguzhan Ozbas, *When Are Outside Directors Effective?*, 96 J. FIN. ECON. 195 (2010) (finding that independent directors do best where the cost of obtaining information about the firm's business is low); Jeffrey L. Coles, Naveen D. Daniel & Lalitha Naveen, *Boards: Does One Size Fit All?*, 87 J. FIN. ECON. 329 (2008) (finding that independent directors do worse when R&D is important). *See* Lehn, *supra* note 36 (finding that the costs of transferring knowledge to independent directors inhibits corporate agility). *See, e.g.*, Frederick Tung, *The Puzzle of Independent Directors: New Learning*, 91 B.U. L. REV. 1175, 1176 (2011).

170. Yuval Deutsch, *The Impact on Board Composition on Firms' Critical Decisions: A Meta-analytic Review*, 31 J. MGMT. 424 (2005) ("The results provide little support to agency theory's predictions on the impact of board composition on critical decisions that involve a potential conflict of interest between managers and shareholders"). *See also* Ronald Anderson & John Bizjak, *An Empirical Examination of the Role of the CEO and the Compensation Committee in Structuring Executive Pay*, 27 J. BANKING & FIN. 1323 (2003) (finding no link between independent directors and executive compensation).

171. Deutsch, *supra* note 170, at 438.

172. Tingle, *Framed!*, *supra* note 142, at 918-22.

173. *See* Brian K. Boyd, *Board Control and CEO Compensation*, 15 STRATEGIC MGMT. J. 335, 339 (1994); John E. Core, Robert W. Holthausen & David F. Larcker, *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 372 (1999); Hamid Mehran, *Executive Compensation Structure, Ownership, and Firm Performance*, 38 J. FIN. ECON. 163, 173 (1995).

174. Eliezer M. Fich & Anil Shivdasani, *Are Busy Boards Effective Monitors?*, 61 J. FIN. 689 (2006).

2. Independent Committees

There is no evidence that the current imperative to create board committees entirely comprised of independent directors improves anything we care about.[175] The most prominent of these board committees is the audit committee, precisely because it is the most intimately connected to the monitoring conception of the board advanced by agency cost theory. Of seven studies looking at earnings accruals as a measure of audit integrity, five failed to find any benefits of having a majority of independent directors on the audit committee, and none found any benefit from the current practice requiring all members of the committee to be independent.[176] Studies that use third party evaluations of financial reporting or the content of earnings announcements to measure audit committee quality also fail to turn up any evidence independent committees do better.[177] Finally, a study of the 87 companies that fraudulently manipulated their financial statements between 1982 and 2000 found that they had the same percentage of independent directors on their audit committees as the control sample.[178]

175. April Klein, *Firm Performance and Board Committee Structure*, 41 J. L. ECON. 275 (1998).

176. *See* April Klein, *Audit Committee, Board of Director Characteristics, and Earnings Management,* 33 J. ACCT. & ECON. 375, 398-399 (2002); Jagdish Pathak et al., *Do Audit Committee and Characteristics of Boards of Directors Influence Earnings Management?* (Mar. 1, 2014) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=24060804; Sonda Marrakchi Chtourou, Jean Bedard & Lucie Courteau, *Corporate Governance and Earnings Management* (Apr. 21, 2001) (unpublished manuscript), http://papers.ssrn.com/sol3/Papers.cfm?abstract-_id=2750534 ("The presence of earnings management is not related to whether the audit committee is composed entirely of independent non-executive directors"); Biao Xie, Wallace N. Davidson III & Peter J. DaDalt, *Earnings Management and Corporate Governance: The Role of the Board and the Audit Committee*, 9 J. CORP. FIN. 295, 305 (2003) (finding that the percentage of independent outside directors on the audit committee is negatively related to discretionary current accruals); Joon S. Yang & Jagan Krishnan, *Audit Committees and Quarterly Earnings Management*, 9 INT'L J. AUDITING 201, 215 (2005) ("We find no significant association between either audit committee independence or audit committee financial expertise and quarterly discretionary accruals"); Aloke Ghosh, Antonio Marra & Doocheol Moon, *Corporate Boards, Audit Committees, and Earnings Management: Pre- and Post-SOX Evidence*, 37 J. BUS. FIN. & ACCT. 1145 (2010) (finding that "earnings management does not vary with board composition and structure, or with audit committee composition, expertise and ownership"); David Larcker, Scott A. Richardson & İrem Tuna, *Corporate Governance, Accounting Outcomes, and Organizational Performance*, 82 ACCT. REV. 963 (2007) (finding no significant association between independence on the board or audit committee and abnormal accruals); Yun W. Park & Hyun-Han Shin, *Board Composition and Earnings Management in Canada*, 10 J. CORP. FIN. 431, 452 (2004).

177. Andrew J. Felo, Srinivasan Krishnamurthy & Steven A. Solieri, *Audit Committee Characteristics and the Perceived Quality of Financial Reporting: An Empirical Analysis* 25 (2003), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=401240 ("audit committee independence is not significantly related to financial reporting quality"); Kirsten L. Anderson, Stuart Gillan & Daniel N. Deli, *Boards of Directors, Audit Committees, and the Information Content of Earnings* 24, (Weinberg Center for Corporate Governance Working Paper No. 4, 2003), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=444241 ("[W]e find that audit committee independence unrelated to the independence of the full board is unrelated to the information content of earnings").

178. David Farber, *Restoring Trust After Fraud: Does Corporate Governance Matter?*, 80 ACCT. REV. 539, 560 (2005; Dain C. Donelson, John M. McInnis and Richar Mergenthaler Jr., *The Effect of Corporate Governance Reform on Financial Reporting Fraud* 3230 (2015) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2138348.

It is worth also considering the performance of independent directors on compensation committees because these committees are closely tied to the core activity of monitoring and constraining agency costs. Seven different studies have found that compensation committees with a higher proportion of independent directors have no significant impact on the level of CEO compensation.[179] The remaining studies find compensation committees comprised entirely of independent directors lead to higher executive pay.[180]

3. Separation of the CEO and Chair Roles

At the beginning of agency cost theory's rise to prominence, Eugene Fama and Michael Jensen each sharply criticized the common American practice of combining the CEO and board chair roles.[181] If the board is to serve as an effective monitor of management, it cannot be the case that it is "run" by the very person it is ostensibly monitoring. The trend since then has been increasing numbers of firms splitting the two positions.[182]

There have been many empirical studies of the question whether separating the CEO and chair positions leads to better outcomes. By the time meta-studies on the question were being completed in 1995 and 1998, it was clear there were,

179. *See* Conyon, *Executive Compensation*, *supra* note 139, at F80 (finding compensation grew post-Dodd-Frank at
the same rate as before, and that growth is unaffected by the composition of the compensation committee); Martin Conyon & Lerong He, *Compensation Committees and CEO Compensation Incentives in US Entrepreneurial Firms*, 16 J. MGMT. ACCT. RSCH. 35, 50-52 (2004); Catherine M. Daily et al., *Compensation Committee Composition as a Determinant of CEO Compensation*, 41 ACAD. MGMT. J. 209, 214 (1998); Harry A. Newman & Haim A. Mozes, *Does the Composition of the Compensation Committee Influence CEO Compensation Practices?*, 28 FIN. MGMT. 41, 50 (1999); Ian Gregory-Smith, *Chief Executive Pay and Remuneration Committee Independence*, 74 OXFORD BULLETIN ECON. & STAT. 510, 528 (2012) (no statistical relationship between CEO compensation and non-independent directors); Martin J. Conyon & Danielle Kuchinskas, *Compensation Committees in the United States*, in HANDBOOK ON INTERNATIONAL CORPORATE GOVERNANCE: COUNTRY ANALYSES 151, 154 (Christine A Mallin, ed., 2006); Nikos Vafeas, *Further Evidence on Compensation Committee Composition as a Determinant of CEO Compensation*, 32 FIN. MGMT. 53, 69 (2003); Anderson & Bizjak, *supra* note 170, at 1326.

180. Kam-Ming Wan, *Can Boards with a Majority of Independent Directors Lower CEO Compensation?* 14 (2009) (unpublished manuscript) (on file with the University of Hong Kong) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1421549; *see* Martin J. Conyon & Simon I. Peck, *Board Control, Remuneration Committees, and Top Management Compensation*, 41 ACAD. MGMT. J. 146, 154 (1998) (finding that CEO pay is higher in firms with compensation committees and those with a greater fraction of independent directors on the committee); Ronald Anderson & John Bizjak, *An Empirical Examination of the Role of the CEO and the Compensation Committee in Structuring Executive Pay*, 27 J. BANKING & FIN. 1323 (2003) (finding compensation committees on which the CEO sits do not award excessive pay or lower overall incentives).

181 Fama & Jensen, Residual Claims, supra note 159, at 331; Fama & Jensen, "Separation", supra note 139, at 314-15. See also Mizruchi, supra note 159.

182. Spencer Stuart, *2020 U.S. Spencer Stuart Board Index* 3 (May 24, 2021) https://www.spencerstuart.com/-/media/2020/december/ssbi2020/2020_us_spencer_stuart_board_index.pdf; Spencer Stuart, *U.S. Board Index 2014* 8 (2014) https://www.nyse.com/publicdocs/nyse/listing/Spencer_Stuart_Board_Index_2014.pdf.

on average, no benefits to having an independent chair.[183] A 2011 review of the research in this area (as well as the research on independence) led to the observation by a team of scholars, "we are not aware of a body of literature in corporate governance—or elsewhere—where null results present with such consistency."[184] When we do see the combined roles making a difference, it is generally positive. For example, CEOs who are also board chairs do better in negotiating takeovers.[185]

4. Summary

The hypothesis that increasing the independence of boards would lead to better outcomes—a logical result of the monitoring conception of the board in agency cost theory—is contradicted by all available evidence. This is true whether we define better outcomes in terms of firm performance, increasing the accuracy of firm reporting, terminating underperforming executives, or controlling the direct expropriation of value from the corporation through executive pay. We have done everything we can to improve market-wide board monitoring with no discernable improvement in outcomes we care about. As a group of finance scholars reviewing the literature recently concluded, "It might be time to concede that our conception of boards as all-encompassing monitors is doubtful . . . Our review calls into question whether boards are really equipped to catch or stop misbehavior."[186] An alternative view might be that independent directors' purported advantages in fulfilling the monitoring function are matched, and even exceeded, by the liabilities arising from those directors' relative ignorance of the business, people, and markets in which the firm operates.[187]

183. Brian Boyd, *CEO Duality and Firm Performance: A Contingency Model*, 16 STRATEGIC MGMT. J. 301, 309 (1995) [hereinafter Boyd, *CEO Duality*]; *see* Dan R. Dalton et al., *Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance*, 19 STRATEGIC MGMT. J. 269, 282 (1998).

184. Dan Dalton & Catherine Dalton, *Integration of Micro and Macro Studies in Governance Research: CEO Duality, Board Composition, and Financial Performance*, 37 J. MGMT. 404, 408 (2011). *See also* Ryan Krause, Matthew Semadeni & Alberta A. Cannella, *CEO Duality: A Review and Research Agenda*, 40 J. MGMT. 256, 282 (2014) ("The most consistent finding in the CEO duality literature is that separating the CEO and board chair positions does not, on its own, improve firm performance").

185. Victor A. Ghazal, CEO Duality and Corporate Stewardship: Evidence from Takeovers 1 (June 29, 2015) (thesis, Grinnell College) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2616464 (combined CEO/Chairs "act as good corporate stewards on behalf of their respective firms and shareholders.").

186. Steven Bovie et al., *Are Boards Designed to Fail? The Implausibility of Effective Board Monitoring*, 10 ACAD. MGMT. ANN. 319, 335 (2016). *See also* Dalton et al., *Fundamental Agency Problem*, *supra* note 15, at 39 ("By agency theory independence standards, these impressive trend lines have led to unprecedented levels of presumably independent oversight. By the central tenets of resource dependent theory…however, networking capacity has been decimated, as has the expertise-experience-reputation element of the resource-based perspective…").

187. *See also* Erkens, Hung & Matos, *supra* note 169 (noting the corporate excess of the dot-com era, the accounting frauds of the Enron era, the widespread stock option backdating scandals, and the governance failures that helped create the 2008 financial crisis, all occurred in an environment of majority

C. Hypothesis 3: Aligning Managers' Interests with those of the Shareholders will Produce Better Outcomes

At the heart of agency cost theory is the observation that agency costs increase as managers' equity interests decline, widening the divide between ownership and control.[188] The conclusion drawn early in the agency cost era was that better aligning managers' interests with those of their principals, the shareholders, would therefore reduce agency costs.[189] This led to an emphasis on managers' owning shares and being compensated through equity incentives or performance programs tied to shareholder outcomes.[190]

1. Equity Ownership

Jensen and Meckling referred to agency theory as "a theory of . . . ownership," and some of the earliest studies on the role of equity incentives in reducing agency costs looked at the impact of managers' shareholdings on firm value.[191] The earliest studies appeared to find that that firm value varied according to changes in executives' shareholdings.[192] However, "when . . . these studies are corrected for missing controls and other problems, the relationship between the division of cash flows and firm performance tends to disappear

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or super-majority independent boards). *See e.g.* David H. Erkens, Mingyi Hung & Pedro Matos, "Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide" 18 *Journal of Corporate Finance* 389 (2012) (finding that during the financial crisis of 2007-2008, the proportion of independent directors was inversely related to stock returns).

188. Jensen & Meckling, *supra* note 1, at 309.

189. *See* Fama & Jensen, *Residual Claims*, *supra* note 159; Iman Anabtawi, *Explaining Pay Without Performance: The Tournament Alternative*, 54 EMORY L. J. 1557, 1561 (2005) ("The optimal contracting model [which starts with agency costs as its basis] underlies most scholarship in the area of executive compensation."); James S. Ang, Rebel A. Cole & James Wuh Lin, *Agency Costs and Ownership Structure*, 55 J. FIN. 81, 82 (2000) ("[A]gency costs increase with a reduction in managerial ownership…").

190. Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57 (1989); Jensen & Meckling, *supra* note 1; Anthony J. Nyberg et al., *Agency Theory Revisited: CEO Return and Shareholder Interest Alignment*, 53 ACAD. MGMT. J. 1029 (2010).

191. Jensen & Meckling, *supra* note 1, at 309; *see also* Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155, 1156 (1985); *see also* Jensen, *Free Cash Flow*, *supra* note 1 (arguing managers with misaligned incentives would invest free cash flow into diversifying activities and low return projects contrary to shareholder interests).

192. Demsetz & Lehn, *supra* note 191; *see, e.g.,* Benjamin E. Hermalin & Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 FIN. MGMT. 101, 111 (1991) (finding that corporate performance increases when management ownership rises to 1% but decreases at higher levels, possibly due to increasing insulation from disciplinary devices that more than offsets the increased alignment of interests between managers and shareholders); *see, e.g.,* Clifford G. Holderness, Randall S. Kroszner & Dennis P. Sheehan, *Were the Good Old Days that Good? Changes in Managerial Stock Ownership Since the Great Depression*, 54 J. FIN. 435, 466 (1999) (finding that managerial ownership nonlinearly increases and then decreases in firm volatility); *see, e.g.,* John J. McConnell & Henri Servaes, *Additional Evidence on Equity Ownership and Corporate Value*, 27 J. FIN. ECON. 595, 604 (1990) (finding that the "ownership structure of equity has an important influence on corporate value"); Randall Morck, Andrei Shleifer & Robert W. Vishny, *Management Ownership and Market Valuation*, 20 J. FIN. ECON. 293, 311 (1988) (finding that as board ownership rises, firm value initially increases, then falls, and finally rises slowly again).

. . ."[193] All of the more recent studies, including several making use of the same earlier data for meta-analysis, consistently find no relationship between insider equity holdings and corporate performance.[194] As a recent literature review concludes, "[w]ith regard to equity holdings, the empirical evidence is . . . enervated. . . . [T]his literature does not provide linkages to corporate financial performance."[195]

2. Equity Incentives

Equity incentives—principally stock options and conditional share grants—were a logical extension of agency theory's expectation that placing managers on the same footing as their principals would lead to superior outcomes.[196] As several prominent finance scholars put it,

"it is well known that a potential solution to the fundamental agency problem is to provide managers with equity stakes in their firms. Thus, managerial self-interest may be mitigated by aligning the interests of managers and shareholders, and it is presumed firm performance will improve as managers concurrently work for their own and shareholders' benefit."[197]

With encouragement from academics and governance actors, the use of equity incentives skyrocketed through the 1990s.[198] In fact, once they entered heavy use, equity incentives became the main contributor to the modern rise in executive compensation.[199] Ironically, a device intended to reduce agency costs actually contributed more than any other practice to double the portion of corporate profits diverted from shareholders to managers.[200]

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193. Goshen & Squire, *supra* note 41, at 815; *see* Dalton et al., *Fundamental Agency Problem*, *supra* note 15, at 16-17.

194. Dalton et al., *Fusion or Confusion*, *supra* note 74, at 20; *see, e.g.*, Sundaramurthy, Rhoades & Rechner, *supra* note 74, at 503; *see, e.g.*, Charles P. Himmelberg, R. Glenn Hubbard & Darius Palia, *Understanding the Determinants of Managerial Ownership and the Link Between Ownership and Performance*, 53 J. FIN. ECON. 353, 381 (1999); *see, e.g.*, Harold Demsetz & Belen Villalonga, *Ownership Structure and Corporate Performance*, 7 J. CORP. FIN. 209, 211 (2001); *see also* Sanjai Bhagat, Bernard Black & Margaret Blair, *Relational Investing and Firm Performance*, 27 J. FIN. RSCH. 1 (2004).

195. Dalton et al., *Fundamental Agency Problem*, *supra* note 15, at 33.

196. George P. Baker, Michael C. Jensen & Kevin J. Murphy, *Compensation and Incentives: Practice vs. Theory*, 63 J. FIN. 593 (1988); Michael C. Jensen & Kevin J. Murphy, *CEO Incentives- It's Not How Much You Pay, But How*, 22 J. APPLIED CORP. FIN. 64 (2010);Jensen, *Free Cash Flow*, *supra* note 1, at 324.

197. Charles P. Himmelberg, R. Glenn Hubbard & Darius Palia, *Understanding the Determinants of Managerial Ownership and the Link Between Ownership and Performance*, 53 J. FIN. ECON. 353, 354 (1999).

198. Brian J. Hall, *What You Need to Know about Stock Options*, 78 HARV. BUS. REV. 122 (2000) ("Options are the best compensation mechanism we have for getting managers to act in ways that ensure the long-term success of their companies and the well-being of their workers and stockholders." at 122)

199. Tingle, *Best Pay Practices*, *supra* note 144, at 394-95.

200. *Id*. See also Bebchuk & Grinstein, *supra* note 143, at 302 (In 1993, the amount paid the five highest employees of a U.S. company absorbed 5 percent of its profits; by 2003 this had increased to 10 percent.)

What did shareholders get for their investment? A 2003 meta-analysis of 229 empirical studies on the question found that, with the exception of earnings per share, management equity exposure had no effect on Tobin's Q, return on assets, return on equity, return on investment, shareholder returns, the market-to-book ratio, or Jensen's Alpha, among other financial metrics.[201] The impact on earnings per share was modest, and the researchers noted it could be attributed to managerial techniques to increase per share earnings without improvements to operating results.[202] This might be done by increasing firm leverage, for example. The authors of the study concluded, "the results of our meta-analyses do not support agency theory's proposed relationship between ownership and firm performance."[203]

Similar results were found by the authors of a 2007 meta-analysis.[204] This study did find evidence that the market had an expectation that equity incentives would improve performance, but "this result is not confirmed by real accounting returns."[205] Stock options have particularly come in for opprobrium; several studies find they are negatively associated with both firm value and future operating results.[206]

The relevant empirical literature also includes a large and growing body of research on the negative impact of equity incentive schemes on executive behavior, including manipulating disclosure at the time of equity awards,[207] delaying or accelerating the release of news,[208] manipulating earnings,[209] and the occurrence of fraud or the indicia of fraud like shareholder litigation.[210] Equity

201. Dalton et al., *Fusion or Confusion*, *supra* note 74, at 19.

202. *Id.* at 20.

203. *Id*.

204. Juan P. Sanchez-Ballesta & Emma Garcia-Meca, *"A Meta-Analytic Vision of the Effect of Ownership Structure on Firm Performance"* 15:5 Corporate Governance 879, 887-88 (2007).

205. *Id*.

206. Michel A. Habib & Alexander Ljungqvist, *Firm Value and Managerial Incentives: A Stochastic Frontier Approach*, 78 J. BUS. 2053, 2054-55 (2005); Michelle Hanlon, Shivaram Rajgopal & Terry Shevlin, *Large Sample Evidence on the Relation Between Stock Option Compensation and Risk Taking*, 35 (2004) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=427260>, archived: <https://perma.cc/YX8D-ZDTB (finding a negative association between option risk-taking incentives and future operating performance).

207. David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. ECON. 73, 75 (2000).

208. *Id*.

209. *See, e.g.*, Natasha Burns & Simi Kedia, *The Impact of Performance-based Compensation on Misreporting*, 79 J. FIN. ECON. 35, 37 (2006); Qiang Cheng & Terry D. Warfield, *Equity Incentives and Earnings Management*, 80 ACCT. REV. 441, 443 (2005); Daniel Bergstresser & Thomas Philippon, *CEO Incentives and Earnings Management*, 80 J. FIN. ECON. 511, 514 (2006); Jap Efendi, Anup Srivastava & Edward P. Swanson, *Why Do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors*, 85 J. FIN. ECON. 667, 670 (2007); Julia Grant, Garen Markarian & Antonio Parbonetti, *CEO Risk-Related Incentives and Income Smoothing*, 26 CONTEMP. ACCT. RSCH. 1029, 1030 (2009).

210. Shane A. Johnson, Harley E. Ryan Jr. & Yisong S. Tian, *Managerial Incentives and Corporate Fraud: The Sources of Incentives Matter*, 13 REV. FIN. 115, 116-17 (2009); Lin Peng & Ailsa Roell, *Executive Pay and Shareholder Litigation*, 12 REV. FIN. 141, 142 (2008); David J. Denis, Paul Hanouna & Atulya Sarin, *Is There a Dark Side to Incentive Compensation?*, 12 J. CORP. FIN. 467, 468 (2006);

compensation is linked to larger restructurings and layoffs,[211] voluntary corporate dissolutions,[212] and declines in corporate R&D and capital expenditures in the years executives' equity vests.[213]

3. Pay-for-Performance

In a popular phrase, Michael Jensen and a co-author noted in 1990 that corporate America paid "its most important leaders like bureaucrats."[214] Their point was that managers ought to be incentivized to take risks (the risk aversion of managers is another frequent assumption of agency theory) and to deliver value to shareholders. This is a suggestion that goes beyond merely aligning the interests of agents with their principals through the use of equity incentives. Pay for performance has become a popular touchstone in discussions about executive compensation.[215] What counts as "performance" varies according to the scheme, but it tends to be tied closely to total shareholder return.[216] As a result, for the past two decades CEO pay has actually closely tracked the returns received by individual firms' shareholders.[217]

Joseph P. O'Connor Jr. et al., *Do CEO Stock Options Prevent or Promote Fraudulent Financial Reporting?*, 49 ACAD. MGMT. J. 483, 492-93 (2006); Jared Harris & Philip Bromiley, *Incentives to Cheat: The Influence of Executive Compensation and Firm Performance on Financial Misrepresentation*, 18 ORG. SCI. 350, 362 (2007).

211. Jay Dial & Kevin J. Murphy, *Incentives, Downsizing, and Value Creation at General Dynamics*, 37 J. FIN. ECON. 261, 305 (1995); Jeffrey T. Brookman, Saeyoung Chang & Craig G. Rennie, *CEO Equity Portfolio Incentives and Layoff Decisions,* 30 J. FIN. RSCH. 259, 260 (2007).

212. Hamid Mehran, George E. Nogler & Kenneth B. Schwartz, *CEO Incentive Plans and Corporate Liquidation Policy*, 50 J. FIN. ECON. 319, 320 (1998).

213. Alex Edmans, Vivian W. Fang & Katharina A. Lewellen, *Equity Vesting and Investment*, (2017) 30:7 REV. FIN. STUD. 2229, 2230.

214. Michael C. Jensen & Kevin J. Murphy, *CEO Incentives-It's Not How Much You Pay, But How*, 68 HARV. BUS. REV. 138, 138 (1990).

215. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 135-36, 139 (2004) [hereinafter BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE](share price movements are largely driven by macro-economic factors such as changes in interest rates, economic growth rates, technological change, and changes to commodity prices; factors that CEOs have little influence over); Michael Faulkender et al., *Executive Compensation: An Overview of Research on Corporate Practices and Proposed Reforms*, 22 J. A CORP. FIN. 107, 113-17 (2010); ROGER L. MARTIN, FIXING THE GAME: BUBBLES, CRASHES, AND WHAT CAPITALISM CAN LEARN FROM THE NFL 25 (2011); Dalton et al., *Fusion or Confusion*, *supra* note 74; Frydman & Jenter, *supra* note 143, at 94-96; Brian L. Connelly et al., *Ownership as a Form of Corporate Governance*, 47 J. MGMT. STUD. 1561 (2010) (summarizing the research since 2000 and concluding it is mixed at 1564-66); Sanchez-Ballesta & Garcia-Meca, *supra* note 204, at 887-88; Habib & Ljungqvist, *supra* note 206, at 2054-55; Hanlon, Rajgopal & Shevlin, *supra* note 206 (finding a negative association between option risk-taking incentives and future operating performance at 35).

216. Tingle, *Best Pay Practices*, *supra* note 144 at 399–401.

217. Conyon, *Executive Compensation*, *supra* note 139, at F62, F79; Ron Schmidt, *The Relationship Between Shareholder Return and CEO Pay Over a CEO's Full Period of Service*, 33 J. APPLIED CORP. FIN. 1 (2021) (finding "a clear and indisputable link between CEO compensation and shareholder return" which is "the most important determinant of variation in the amount paid CEOs over their complete tenures" at 1); Michael Faulkender et al., *Executive Compensation: An Overview of Research on Corporate Practices and Proposed Reforms*, 22 J. APPLIED CORP. FIN. 107 (2010) (noting "a number of recent studies strongly suggest that pay has become more aligned with performance over time) at 109.

There is very little evidence that performance pay schemes (whether they consist of cash or equity awards) improve corporate performance.[218] Professor Michael Dorff summarizes the empirical literature,

"Respected scholars who have carefully combed through the literature on this question—including some who favour performance pay—have concluded that there is no empirically demonstrable relationship between firms' use of performance pay and their success in the marketplace."[219]

Several studies have found performance pay schemes actually harm corporate financial performance.[220] The most recent of these finds that incentive pay not only does not result in better performance, but "translate[s] into lower future shareholder wealth."[221] If these results seem counterintuitive, it may be helpful to consider that there are a number of behavioral experiments demonstrating the presence of large incentives actually cause subjects to perform worse at high-level tasks that require creative or analytical thought.[222]

218. Murphy, *Executive Compensation*, *supra* note 143 ("[u]nfortunately, although there is a plethora of evidence on dysfunctional consequences of poorly designed pay programs, there is surprisingly little direct evidence that higher pay- performance sensitivities lead to higher stock-price performance." at 2539); Dennis Wright Michaud & Yunwei Gai, *CEO Compensation and Firm Performance* 6-7 (2009) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id= 1531673>, archived: <https://perma.cc/GV6U-N88P (noting that the popular belief in the link between pay for performance and corporate outcomes is not supported by empirical studies).

219. Dorff, *supra* note 148, at 128. *See also* Lund & Polsky, *supra* note 148, at 689-706 (detailing the reasons to believe pay for performance remuneration schemes' marginal benefit are quite low).

220. Matt Bloom & George T. Milkovich, *Relationships Among Risk, Incentive Pay, and Organizational Performance*, 41 ACAD. MGMT. J. 283, 285 (1998); H. Young Baek & Josh A. Pagan, *Executive Compensation and Corporate Production Efficiency: A Stochastic Frontier Approach*, 41 Q. J. BUS. ECON. 27 (2002) (CEO pay tied to long term firm performance could result in sacrificing the long-term financial performance for short term successes at 39); Michael J. Cooper, Huseyin Gulen & P. Raghavendra Rau, *The Cross-Section of Stock Returns and Incentive Pay*, (Working Paper, 2011) https://www.researchgate.net/ profile/Prau/publication/228273541_PerformanceforPayTheRelation Between CEO Incentive Compensation and Future Stock Price Performance/links/54e71cc 70cf277664ff794d2.pdf (finding incentive pay negatively correlated to shareholder wealth changes); Michael J. Cooper, Huseyin Gulen & P. Raghavendra Rau, *Performance for Pay? The Relation Between CEO Incentive Compensation and Future Stock Price Performance*, (2016) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1572085 (managerial compensation intended to align interests with shareholder value do not always translate into higher future returns, and for firms with high paid CEOs, can actually translate to lower future shareholder wealth) [hereinafter Cooper, Gulen & Rau, *Performance for Pay?*].

221. Cooper, Gulen & Rau, *Performance for Pay?*, *supra* note 220.

222. Edward L. Deci, Richard Koestner & Richard M. Ryan, *A Meta-Analytic Review of Experiments Examining the Effects of Extrinsic Rewards on Intrinsic Motivation*, 125 PSYCHOL. BULL. 627, 628-29 (1999). *See also* Roland Banabou & Jean Tirole, *Intrinsic and Extrinsic Motivation*, 70 REV. ECON. STUD. 489 (2003) (concluding that "incentives are only weak reinforcers in the short run, and negative reinforcers in the long run" at 492); *see* the discussion in Dorff, *supra* note 148, at 137-46; Colin F. Camerer & Robin M. Hogarth, *The Effects of Financial Incentives in Experiments: A Review and Capital-Labor-Production Framework*, 19 J. RISK & UNCERTAINTY 7 (1999) (a review of 74 studies found that "incentives sometimes improve performance, but often don't" at 34); Dan Ariely et al., *Large Stakes and Big Mistakes*, 76 REV. ECON. STUD. 451 (2009) (the experiment revealed that high monetary incentives resulted in lower performance at 458-59).

Finally, as with equity incentives, pay-for-performance schemes appear to be associated with financial fraud and accounting restatements.[223] One of the possible reasons for this is that it turns out CEOs probably do not, in most cases, have much control over the market value of their firms.[224] One study found the difference in talent between the best CEO in the U.S. and the 250th best CEO gave rise only to a 0.016 percent increase in market capitalization.[225] Tying life-changing financial rewards to something most CEOs can only indirectly affect creates perverse incentives.[226]

4. Summary

The normative program drawn from agency cost theory is relatively crude, and nowhere is that more obvious than in relation to the hypothesis about using equity holdings or compensation to align managers' interests with those of the shareholders. In focusing on one thing—the possibility that managers might

223. Bruno S. Frey & Margit Osterloh, *Yes, Managers Should Be Paid Like Bureaucrats*, 14 J. MGMT. INQUIRY 96, 97 (2005) (it has been proven that where CEO compensation is linked to performance, there is a high probability for fraudulent accounting); Harris & Bromiley, *supra* note 210, at 352 (linking pay to performance by having options form a high percentage of CEO pay diverts focus from long-term firm performance to short-term benefits, creating an incentive for illicit behavior like misrepresenting firm performance by inflating stock prices); Denis, Hanouna & Sarin, *supra* note 210, at 470 ("As the use of stock options increases, the expected payoff from fraud increases."); David A. Becher, Terry L. Campbell II & Melissa B. Frye, *Incentive Compensation for Bank Directors: The Impact of Deregulation*, 78 J. BUS. 1753, 1759 (2005) (equity-based compensation encourages bank managers to take on unjustifiable financial risks); Qiang Cheng & David B. Farber, *Earnings Restatements, Changes in CEO Compensation, and Firm Performance*, 83 ACCT. REV. 1217, 1246 (2008) (a positive relation exists between CEO option based compensation and likelihood of earnings restatement; firms that experience earnings restatement often resort to decreasing CEO equity holdings); James C. Spindler, *Endogenous Compensation in a Firm with Disclosure and Moral Hazard,* (USC Gould School of Law Working Paper, Paper No. C09-20, 2009), http://weblaw.usc.edu/assets/ docs/contribute/CO9_20_paper.pdf, at 2 ("performance-based compensation rewards the faking of performance"); Martin, *supra* note 215, at 5-6 (incentives in the form of stock options paid to CEOs "gave managers the incentive to take risky actions: if the risks worked out, the managers got rich; if they didn't, the managers were largely unaffected, regardless of the damage to the company"); Faulkender et al., *supra* note 215, at 113-114, 116 (executives have been known to manipulate accounts and timing disclosures in order to maximize short-term gains generated from stock options held; as a result, executive compensation has become a focus for regulators following the financial crisis).

224. Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q. J. ECON. 49, 50 (2008). *See also* Marianne Bertrand & Antoinette Schoar, *Managing with Style: The Effect of Managers on Firm Policies*, 118 Q. J. ECON. 1169, 1190-91 (2003) (examining five hundred executives in six hundred large firms over thirty years and finding leadership changes accounted for only 3-4% of differences in corporate performance).

225. Gabaix & Landier, *supra* note 224, at 50. *See also* VICTOR BRUDNEY & MARVIN A. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE, 1153 (2nd ed.1979) (one-third to one-half of fluctuations in share prices are attributable to market-wide causes); Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q. J. ECON. 901, 906-908 (2001) (demonstrating that CEOs are compensated based on firm performance; performance that is dictated by factors not within their control, such as international oil prices); Dirk Jenter & Fadi Kanaan, *CEO Turnover and Relative Performance Evaluation*, 70 J. FIN. 2155, 2175-77 (2015) (external industry and market shocks like recessions affect CEO turnover, yet these are factors beyond a CEO's control); Bebchuk & Fried, *Pay Without Performance*, *supra* note 215, at 139 (arguing share price movements are largely driven by macro-economic factors).

226. Martin, *supra* note 215, at 27-30.

ignore shareholder value—agency cost theory ignored many other important things: the fact that managers are motivated by things like a concern for their reputation, a desire to succeed at something challenging, satisfaction at solving problems, a desire to feel useful, loyalty to their subordinates, and a desire not to let down the employees and other corporate constituencies. It paid no attention to the way supercharged incentives could crowd out these pro-social motivations.[227] It paid no attention to how a focus on financial metrics could crowd out the important non-financial objectives that can only be poorly measured, such as customer satisfaction, product innovation, and employee morale.[228] Unsurprisingly, research finds executives tend to work on incentivized tasks rather than those that are not measured.[229] Finally, the normative agency cost project also ignored the ways in which the interests of shareholders could deviate from that of the firm in ways that made managerial alignment counterproductive.[230]

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227. Lynn A. Stout, *Killing Conscience: The Unintended Behavioral Consequences of "Pay for Performance"*, 39 J. CORP. L. 525, 546-47, 554-55 (2014). *See also* Ernst Fehr & Simon Glichter, *Do Incentive Contracts Undermine Voluntary Cooperation*? 1 (Inst. for Empirical Research in Economics University of Zurich Working Paper, Paper No. 34, 2002) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=313028, 1 (financial incentives may undermine voluntary cooperation and produce less efficient outcomes than fixed rewards); Uri Gneezy & Aldo Rustichini, *A Fine is a Price*, 29 J. LEG. STUD. 1, 3 (2000); Carl Mellström & Magnus Johannesson, *Crowding Out in Blood Donation: Was Titmuss Right?*, 6 J. EUR. ECON. ASS'N 845, 857 (2008); DAN ARIELY, PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS 71 (2008); Stewart J. Schwab & Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?*, 63 WASH. & LEE L. REV. 231, 240-41 (2006) (finding that one-third of Fortune 500 CEOs had no written employment agreement and another third had very basic agreements that contained only their pay and a few of their duties); *see, e.g.*, DANIEL H. PINK, DRIVE: THE SURPRISING TRUTH ABOUT WHAT MOTIVATES US 26-58 (2009) (describing how multiple experiments that show monetary incentives often reduce performance on tasks requiring creativity and persistence); *Pay for Performance - Does It Work?*, High Pay Centre (Nov. 11, 2013), http://highpaycentre.org/blog/pay-for-performance- does-it-work,[https://perma.cc/9QJR-DYMP] (bonuses are no longer seen as appreciation for exceptional performance but are now believed to be part of payment for work done); Bruno S. Frey & Felix Oberholzer-Gee, *The Cost of Price Incentives: An Empirical Analysis of Motivation Crowding-Out*, 87 AM. ECON. REV. 746, 753-54 (1997); Alfie Kohn, *Why Incentive Plans Cannot Work*, 71 HARV. BUS. REV. 54, 58-59 (1993); Canice Prendergast, *Intrinsic Motivation and Incentives*, 98 AM. ECON. REV. 201, 204 (2008); Martha Lagace, *Pay-for-Performance Doesn't Always Pay Off* Harvard Business School Working Knowledge (Apr. 14, 2003), http://hbswk.hbs.edu/item/pay-for-performance-doesnt-always-pay-off.

228. Christopher D. Ittner & David F. Larcker, *Coming Up Short on Nonfinancial Performance Measurement*, 81 HARV. BUS. REV. 88, 90-92 (2003).

229. Roland Banabou & Jean Tirole, *Bonus Culture: Competitive Pay, Screening and Multitasking*, 124 J. POL. ECON. 305, 313-14 (2016); Robert Gibbons, *Incentives Between Firms (And Within)*, 51 MGMT. SCI. 2, 6 (2005) (arguing that performance goals should not be limited to achieving objective targets but should include relational aspects that enable a firm to navigate difficult unforeseen events).

230. United Kingdom, Department for Business, Innovation & Skills, *The Kay Review of UK Equity Markets*

and Long-Term Decision Making, by John Kay 33-34 (London: Business, Innovation Skills, 2012), archived: <https://perma.cc/G7Y6-7FZF [hereinafter The Kay Report]; Patrick Bolton, Jose Scheinkman & Wei Xiong, *Executive Compensation and Short-Termist Behaviour in Speculative Markets*, 73 REV. ECON. STUD. 577, 579 (2006) (arguing that shareholder intervention may not necessarily prompt CEOs to focus on firms' long-term performance, especially where shareholder interests are of a short-term nature: mainly holding equity purely for speculative purposes); Mahabaleswara Bhatta H.S., *Kinetics of Individual Investors' Behavior-A Conceptual View*, 1 INT'L J. APPLIED FIN. MGMT. PERSP. 39, 39 (2012);

D. Hypothesis 4: The Market for Corporate Control is an Important Mechanism for Controlling Agency Costs

From the outset, agency cost theory was understood to strongly support a robust market for corporate control.[231] Some of the earliest law review articles making use of agency theory emphasized the role of takeovers "in monitoring the performance of corporate managers."[232] As Ronald Gilson noted in 1981, takeover defenses were particularly inappropriate because of the way they frustrated the market for corporate control's ability to reduce agency costs.[233] Takeovers have several aspects that make them congenial to agency cost analysis: a premium is paid, which suggests the change in management increases firm value by reducing agency costs, and the shareholders of the target must tender their shares, which suggests they have independently come to the conclusion that the existing managers will not reduce the relevant agency costs if left in charge.[234] Best of all, a hostile takeover does not require the cooperation of self-interested managers.

1. Hostile Takeovers and Agency Costs

The agency cost explanation for takeovers finds little support in the empirical literature. After studying two thousand companies targeted for acquisition, Anup Agrawal and Jeffrey Jaffe concluded, "[o]verall, we do not find much support for the inefficient management hypothesis. Target firms as a group do not underperform over a decade-long pre-bid period, whether performance is measured by operating returns or stock returns."[235] A study of the companies

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JOHN C. BOGLE, THE CLASH OF THE CULTURES: INVESTMENT VS. SPECULATION 1 (2012); Bryce C. Tingle, *Bad Company! The Assumptions Behind Proxy Advisors' Voting Recommendations*, 37 DAL. L. 709, 735-38 (2014) [hereinafter Tingle, *Bad Company*].

231. Michael C. Jensen, *Takeovers: Folklore and Science*, 62 HARV. BUS. REV. 109 (1984); Jensen, *Free Cash Flow*, *supra* note 1; Michael C. Jensen, *The Takeover Controversy; The Restructuring of Corporate America*, 53 VITAL SPEECHES OF THE DAY 426 (1987); Michael C. Jensen, *Takeovers: Their Cause and Consequences*, 2 J. ECON. PERSP. 21 (1988); Michael C. Jensen, *Eclipse of the Public Corporation*, (1989) 67:5 Harv. Bus. Rev. 61 (1989); Michael C. Jensen, *Agency Costs of Overvalued Equity*, 34 FIN. MGMT. 5 (2005); NEIL FLIGSTEIN, THE TRANSFORMATION OF CORPORATE CONTROL (1990); Michael C. Jensen & R. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983); J. P. Walsh & J. W. Ellwood, *Mergers, Acquisitions, and the Pruning of Managerial Deadwood*, 12 STRAT. MGMT. J. 202 (1991).

232. Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 737 (1982); Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982).

233. Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981).

234. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 117 (1965).

235. Anup Agrawal & Jeffrey F. Jaffe, *Do Takeover Targets Underperform? Evidence from Operating and Stock Returns*, 38 J. FIN. QUANTITATIVE ANALYSIS 721, 722 (2003). *See also* Stefan Luthringshauser & Julinda Nuri, *The Mystery of the Market for Corporate Control: Takeover Likelihood of Underperforming Firms* 15 (2012), www.ssrn.com/ abstract=2126509 (finding results that "contradict the general wisdom that the market for corporate control penalises underperforming companies"); See

targeted for acquisition in the takeover frenzy of the 1980s found that more than half of them had outperformed the market over the previous two years.[236]

There are almost no modern studies about firms that survive as independent concerns following an unsolicited bid, though there is anecdotal evidence that some of them, at least, outperform their peers.[237] One of the only statistical studies on this topic found that companies that successfully resisted a takeover outperformed their peers by 40 percent over the following five years, but only if they increased their leverage.[238]

When we look at what occurs following a successful takeover bid, there is again little evidence for the agency cost story. The fact that bidders overpay for acquisitions is, at this point, proverbial.[239] Long-term studies that measure operating performance over time, such as earnings or other accounting measures, largely find that acquirors underperform their peers for the next several years.[240] Hostile bids, the ideal mechanism for circumventing expensive managers, result in worse acquiror stock performance than friendly deals.[241] Another study found no evidence of the post-acquisition turnover of officers and directors that we would expect if we accepted the disciplining effect assumed by agency cost theory.[242] Thus, there is little in the literature to suggest that takeovers arise from agency costs remedied by a successful bidder.

2. Takeover Defenses

Because takeover defenses inoculate managers against the discipline of the market for corporate control, agency cost theory assumes that they permit

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also, Rajeeva Sinha, *The Role of Hostile Takeovers in Corporate Governance*, 14 Applied Fin. Econ. (2004) 1291 ("the empirical estimates do not support the view that the inernal governance mechanisms in firms subject to a hostile takeover bid are likely to be associated with poor performance" at 1292).

236. James P. Walsh & Rita D. Kosnik, *Corporate Raiders and their Disciplinary Roles in the Market for Corporate Control,* 36 ACAD. MGMT. J. 671 (1993).

237. Yvan Allaire & François Dauphin, *The Value of "Just Say No": A Response to ISS*, (Nov. 6, 2014), https://igopp.org/wp-content/uploads/2015/02/IGOPP_Article_Template2014_ValueJustSayNo_EN_v61.pdf (examination of four companies: NRG Energy, AirGas, Casey's and Illumina); Sabastian V. Niles, *Shareholder Returns of Hostile Takeover Targets*, (Oct. 24, 2014), https://corpgov.law.harvard.edu/2014/10/24/shareholder-returns-of-hostile-takeover-targets (looking at Terra Industries); Martin Lipton, *Just Say No*, (9 Dec. 9, 2014), https://corpgov.law.harvard.edu/2014/12/09/just-say-no (looking at McGraw-Hill).

238. Assem Safieddine & Sheridan Titman, *Leverage and Corporate Performance: Evidence from Unsuccessful Takeovers*, 54 J. FIN. 547 (1999).

239. Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597 (1989); Marina Martynova & Luc Renneboog, *A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand?*, 32 J. BANKING & FIN. 2148 (2008). *See also* David R. King et al., *Meta-Analyses of Post-Acquisition Performance: Indicators of Unidentified Moderators*, 25 STRATEGIC MGMT. 187 (2004) (finding zero or slightly negative returns to acquirors); Sara B. Moeller, Fredrik P. Schlingemann & René M. Stulz, *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave*, 60 J. FIN. 757 (2005) (finding substantial losses in value by acquiring firms).

240. Martynova & Renneboog, *supra* note at 239, at 2168.

241. Marc Goergen & Luc Renneboog, *Shareholder Wealth Effects of European Domestic and Cross-border Takeover Bids,* 10 EUR. FIN. MGMT. 9 (2004).

242. Walsh & Kosnik, *supra* note 236.

managers to increase their waste or diversion of the shareholders' property. One of the most famous attempts to measure freedom from the market for corporate control is called the "E-Index", where "E" stands for "entrenchment."[243]

Unfortunately, a great deal of the research on takeover defenses relies in whole, or in part, on treating the presence of poison pills, anti-takeover statutes, and certain charter provisions as meaningful indicia of firms' ability to stand off a hostile bid.[244] As various legal academics have pointed out, these "defenses" either have no relevance to resisting a hostile bidder, or, like the pill, they can be adopted at a moment's notice, so their absence outside of a bid context reveals nothing about the company or its managers.[245] In contrast, staggered (or "classified") boards, when combined with a pill (it doesn't matter when the pill is adopted) serve as an absolute bar to a hostile bid.[246] Staggered boards are thus the real indicia of "entrenched" managers.

The early research around staggered boards had significant problems.[247] Recent research, with larger and longer-term data sets, find that staggered boards either have no material effect on firm value[248] or they increase it.[249] Studies that

243. Lucian A. Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009); Tingle, *Can We Measure It?*, *supra* note 13 (comprehensive review of the empirical evidence on the validity of these indices) and *see* The President and Fellows of Harvard College, *Links to 1002 Studies that Use the Entrenchment Index (Bebchuk, Cohen, and Ferrell, 2009)*, (Oct. 2020), www.law.harvard.edu/faculty/bebchuk/studies.shtml.

244. *See* the discussion of this point in Tingle, *Two Stories*, *supra* note 111, at 99-102.

245. Klausner, *Factor and Fiction*, *supra* note 59, at 1365; Emiliano M. Catan & Marcel Kahan, *The Law and Finance of Antitakeover Statutes*, 68 STAN. L. REV. 629 (2016) ("[c]orporate lawyers and academics generally dismiss these antitakeover statutes as irrelevant." at 632); John C. Coates, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 286-87 (2000); Klausner, *Some Steps Forward*, *supra* note 60, at 19, 31-33; *see* David F. Larcker et al., *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431 (2011) [hereinafter Larcker et al., *Market Reaction*].

246. *Air Products and Chemicals Inc. v Airgas Inc.* (2011)16A 3D 48 at 657-658 (657-58) ("no bidder to my knowledge has ever successfully stuck around for two years and waged two successful proxy contests to gain control of a classified board in order to remove a pill.")

247. Tingle, *Two Stories*, *supra* note 111 at 101-104 (101-04).

248. Yakov Amihud, Markus Schmid & Steven Soloman, *Do Staggered Boards Affect Firm Value?*, 30 J. APPLIED CORP. FIN. 61 (2018); Yakov Amihud et al., *New Law Reviews Study Findings Recently Were Reported by Y. Amihud and Co-Researchers (Settling the Staggered Board Debate)*, POLITICS & GOV. BUS. 98 (2019) ("The effect of a staggered board is idiosyncratic; for some firms, it increases value, while for other firms it is value destroying").

249. K.J. Martijn Cremers, Lubomir P. Litov & Simone M. Sepe, *Staggered Boards and Firm Value, Revisited*, 126 J. FIN. ECON. 422, 431, tab 4, 441 (2017)(finding that between 1978–2015 "staggering up (down) [in a given] year is associated with an increase (decrease) in Tobin's Q" of approximately 3% in the same fiscal year, of 4.2% over the next year, and a cumulative increase of 7.4% over the next four fiscal years); Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67, 103-104 (2016) (between 1978–2011, although firms with staggered boards are 2.6% lower than average, when industry fixed effects are replaced by firm fixed effects, "staggered boards have an average overall impact on firm value–resulting from combining the changes experienced by firms that stagger up and by firms that stagger down–that is positive and equal to 3.7%."). Two of the most prominent authors of the earlier research defended this in: Lucian A. Bebchuk & Alma Cohen, *Recent Board Declassifications: A Response to Cremers and Sepe*, (2017) (unpublished), https://ssrn.com/abstract=2970629. Cremers et al., in more recent studies, responded convincingly (to this author anyways) in: Martijn Cremers & Simone M. Sepe, *Board Declassification Activism: Why Run Away from the Evidence?* (2017) (unpublished), https://ssrn.com/abstract=2991854 ("This reply responds

have looked at exogenous events that impact corporations' use of staggered boards reinforce this picture. For example, research arising from the Harvard Shareholders Rights Project, which targeted firms for declassification without regard to other characteristics of those firms, caused "economically and statistically significant reductions in firm value…both in absolute terms and relative to declassifications occurring [at other firms]."[250] These wealth effects appear largely to have arisen from affected firms with high R&D expenditures.[251] Other studies making use of various exogenous events impacting corporate use of staggered boards consistently find these types of boards are value-enhancing.[252] The seldom-used "dead hand" poison pills, which serve as a kind of proxy for staggered boards since they can only be lifted by the directors that imposed it, apparently are also associated with wealth gains to shareholders.[253]

There are comparatively fewer studies that look at the impacts of staggered boards on matters other than firm value. What studies exist also contradict the expectations of agency cost theory. Staggered boards are just as likely to terminate a CEO as a board elected annually.[254] The existence of a staggered board has no impact on the amounts paid to executives, nor the pay structures used by the firm.[255] Banks with classified boards were 19–26 percent less likely to require state bailouts following the 2008 financial crisis.[256] None of this suggests "entrenchment" has the effects predicted by agency cost theory.

3. Summary

Agency cost theory cannot explain the market for corporate control. On average, takeovers apparently have little to do with replacing underperforming managers, and takeover defenses do not lead to an increase in managerial self-

to the Bebchuk-Cohen critique. Our analysis demonstrates that their critique remains essentially silent on the main result [of Cremer's and Sepe's research], namely that firm values on average significantly declined after…declassifications." at 3) [hereinafter Cremers & Sepe, *Board Declassification Activism*].

250. Cremers & Sepe, *Board Declassification Activism*, *supra* note 249, at 2; *see also* Martijn Cremers & Simone M. Sepe, *Board Declassification Activism: The Financial Value of the Shareholder Rights Project*, (2017) (unpublished), https://ssrn.com/abstract=2962162.

251. *Id.* at 5-6.

252. Robert Daines et al., *Can Staggered Boards Improve Value? Evidence from the Massachusetts Natural Experiment*, (Harvard Bus. Sch. Working Paper No. 16-105, 2018) 26, https://www.hbs.edu/faculty/Publication%20Files/16-105_554d24a7-64bf-4f71-9b51-4d3391971106.pdf (noting a law passed in Massachusetts that imposed a staggered board on all firms incorporated in that state produced significant and positive average increases in Tobins Q); Larcker et al., *Market Reaction*, *supra* note 245, at 431 (finding that the market reaction to regulatory announcements impacting staggered boards in every case suggests staggered boards are value-enhancing).

253. Katharine Gleason & Mark Klock, *Is There Power Behind the Dead Hand? An Empirical Investigation of Dead Hand Poison Pills*, 7 CORP. OWNERSHIP & CONTROL 2 (2008).

254. Cremers, Litov & Sepe, *supra* note 249, at 433.

255. Martijn Cremers et al., *CEO Pay Redux*, 96 TEX. L. REV. 205, 246 (2017).

256. Daniel Ferreira et al., *Shareholder Empowerment and Bank Bailouts*, (IDEAS Working Paper Series, 2013) 3, 17, 18, http://ideas.repec.org.ezproxy.lib.ucalgary.ca/p/ehl/lserod/56083.html, (creating an index of management insulation that takes into account not only classified boards, but whether–under the relevant state corporate law–classified boards actually serve as an effective takeover defense).

dealing or underperformance. Agency theory's failures in this area likely result from its myopic focus on only one aspect of the firm. Doubtless, there are agency cost-driven takeovers, but these are swamped in the statistics by takeovers where agency costs are not relevant and the premium paid to shareholders is extracted from employees, debtholders, or the acquiring firm's own shareholders.[257] More positively, some premiums might arise from business synergies, including a reduction in product market competition following the acquisition.[258] However, premiums do not appear to mainly arise from reducing agency costs.

At this point, the failure of agency cost theory to predict the ways managers protected by takeover defenses will behave should not seem extraordinary. It is worth noting, however, that the agency cost assumption that managers' self-interest automatically lies in resisting exposure to the market for corporate control is absurd to anyone with actual experience in that market. Managers have golden parachutes, severance clauses, and retention bonuses that pay out fortunes after a change of control.[259] This is in addition to the money executives make on their equity.[260] As nearly all takeovers occur at a substantial premium to the market, managers who sell their firms gain the reputational credit of providing investors with a lucrative exit. Most takeovers are, in fact, friendly.[261]

E. Hypothesis 5: Because the Principal-Agent Relationship Exists in all Firms, there are Best Practices Generalizable Across Firms

Agency cost theory, like any theory, claims to transcend the particular and arrive at the universal. It doesn't merely describe what happens at a few firms;

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257. Bill Francis et al., *The Effect of State Antitakeover Laws on the Firms' Bondholders*, 96 J. FIN. ECON. 127, 129 (2010); Lynn A. Stout, *Takeovers in the Ivory Tower: How Academics Are Learning Martin Lipton May Be Right*, 60 BUS. LAW. 1435, 1441 (2005); Ling Cen, Sudipto Dasgupta & Rik Sen, *Discipline or Disruption? Stakeholder Relationships and the Effect of Takeover Threat*, 62 MGMT. SCI. 2820, 2822 (2016) (finding a positive effect of U.S. business combination statutes on the performance of firms with important principal customers. These firms respond to the imposition of the statutes by reducing their selling, general and administrative expenses as a proportion of sales, suggesting takeovers are expected to result in the expropriation of value from customers); Dalton et al., *Fundamental Agency Problem*, *supra* note 15, at 25-26 (summarizing criticisms of the market for corporate control); R. Edward Freeman & John F. McVea, *A Stakeholder Approach to Strategic Management*, *in* HANDBOOK OF STRATEGIC MANAGEMENT (M. Hitt, E. Freemand & J. Harrison, eds., 2001) 18; Hema A. Krishnan, Michael A. Hitt & Daewoo Park, *Acquisition Premiums, Subsequent Workforce Reductions and Post-Acquisition Performance*, 44 J. MGMT. STUD. 709 (2007) (finding takeover premiums are linked to the number of people laid off after a successful bid); Moeller, Schlingemann & Stulz, *supra* note 239 (finding acquiring firm shareholders lost about 12% of their investment in acquiring firms).

258. *But see* DAVID LARCKER & BRIAN TAYAN, CORPORATE GOVERNANCE MATTERS: A CLOSER LOOK AT ORGANIZATIONAL CHOICES AND THEIR CONSEQUENCES 317 (2d ed, 2015) (discussing findings that acquisitions in the same industry as the bidder produce no performance advantage over acquisitions in an unrelated industry).

259. *See* Jeffrey Marshall, *Looking Hard at Executive Pay*, 22 FIN. EXECUTIVE 36 (2006).

260. Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 55-61 (2003) (discussing norms that often prevent executives from selling material amounts of their equity while still employed by the firm).

261. Mathew Cain et al., *Do Takeover Laws Matter? Evidence From Five Decades of Hostile Takeovers*, J Fin. Econ. (2017) 464, 465 (noting that hostile takeovers have declined to approximately 8.6% of total M&A transactions).

rather, it explains the outcomes experienced by most, if not all, firms.[262] This has certainly been how agency cost theory has been understood by the constituencies that make use of it. Not long after the theory developed, academics and regulators were arguing certain corporate structures and practices were superior.[263] By the time of the UK's influential Cadbury Report in 1992, it seemed reasonable to most observers that there were "best practices" in corporate governance, even if they might disagree with the specific ones selected by the report's authors.[264]

1. Individual Best Practices

In considering the hypotheses around shareholder influence, monitoring boards, the market for corporate control, and executive compensation, we have seen that every recommended practice fails to find much support in the empirical literature. That is, the normative version of agency cost theory fails to produce successful general predictions about corporate governance.

Two objections could be raised about making overall conclusions about agency cost theory from the best practices we have considered. First, agency cost theory may be capable of generating predictions about corporate behavior and performance that will prove true of most companies; we just haven't looked at the right predictions. It is certainly the case that in testing this hypothesis I am attempting to demonstrate a negative. There is always the possibility that there is a rich vein of generally useful practices that arise out of some aspect of agency theory, but it seems unlikely. After forty years, we don't seem to have discovered such a group of practices. More importantly, in looking at the market for corporate control, the monitoring board, shareholder power, and employment incentives, we have examined what nearly all observers have historically regarded as the core insights of agency theory. None of the basic predictions derived from those insights appear to be accurate. It seems unlikely that a peripheral corollary of agency theory will suddenly be discovered to accurately predict governance outcomes.

The second potential objection is that the best practices we have examined are too crude. For example, the problem with the research on monitoring boards

262. Gilson & Gordon, *The Rise of Agency*, *supra* note 106, at 8-9; Brian Cheffins, Using Theory to Study Law: A Company Law Perspective 58 Cambridge L. J. (1999) 197, 210.

263. Cheffins, *History of Corporate Governance*, *supra* note 38; Brian R. Cheffins, *Delaware and the Transformation of Corporate Governance*, 40 DEL. J. CORP. L. 1 (2015); Anita Anand, Frank Milne & Lynnette Purda, *Voluntary Adoption of Corporate Governance Mechanisms*, 1 (Working Paper No. 1112, 2006), papers.ssm.com/sol3/papers.cfm?abstract_id=921450 (examining the extent to which firms voluntarily adopt recommended but not required corporate governance practices); Carol Liao, *A Canadian Model of Corporate Governance*, 37 DAL. L.J. 559 (2014) [hereinafter Liao, *Canadian Model*].

264. *See* UK, COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE, THE REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (1992). For a discussion on the role of Cadbury committee in advancing best practices, *see*: Jay Dahya, John J. McConnell & Nicholaos G. Travlos, *The Cadbury Committee, Corporate Performance and Top Management Turnover*, 57 J. FIN. 461 (2002); Anna Zalewska, *Challenges of Corporate Governance: Twenty Years After Cadbury, Ten Years After Sarbanes-Oxley*, 27 J. EMPIRICAL FIN. 1, 5 (2014).

is that scholars' market-wide evaluations of the best practices' merits have failed to take account of various personal and corporate factors that do lead to better outcomes from independent directors. For instance, research suggests that independent directors are more valuable to non-technical companies.[265] Independent directors have a beneficial influence on CEO pay if the directors make less money or if the directors are much older or younger than the CEO.[266] Similarly, splitting the CEO and board chair role is not especially bad in companies that do not have significant knowledge assets (measured as patent citations and R&D spending) or that are relatively straightforward.[267] The impacts of the CEO also serving as chair also appears to vary according to the stage the CEO is at in their own career, where the firm is at in the CEO succession process, the size of the board, the size of the CEO's shareholdings, and the degree of the CEO's reputation risk.[268] The problem with findings like these are that they are not generalizable. Far from agency cost theory generating predictions that prove to be true as a function of the corporate form (the compelling initial promise of agency theory), it turns out that corporate outcomes depend on a host of idiosyncratic variables. This permits agency cost theory to provide retrospective explanations, but not useful prospective suggestions for corporate practice. In other words, if too many variables are required, agency theory ceases to be a useful theory and instead becomes a series of just-so stories explaining how a highly contingent outcome came to be.

In fact, the research about corporate governance is full of interesting, fine-grained distinctions that produce different outcomes. While the results are often explained with reference to agency cost theory, it is not clear what the theory is contributing. If we asked an informed observer whether greater board independence would benefit a particular company, they would be required to engage in a particularized analysis of the firm's circumstances, personalities,

265. Duchin, Matsusaka & Ozbas, *supra* note 169.

266. Brian Main, Charles O'Reilly & James Wade, *The CEO, the Board of Directors and Executive Compensation: Economic and Psychological Perspectives*, 4 IND. CORP. CHANGE 293, 319-20 (1995); Charles O'Reilly, Brian Main & Graef Crystal, *CEO Compensation as Tournament and Social Comparison: A Tale of Two Theories*, 33 ADMIN. SCI. Q. 257, 261-62 (1988) (finding that independent members of the CEO Compensation committee are likely to pass judgment about appropriate CEO compensation by comparing the CEO's salary to their own).

267. Jinyu He & Heli Wang, *Innovative Knowledge Assets and Economic Performance: The Asymmetric Roles of Incentives and Monitoring*, 52 ACAD. MGMT. J. 919 (2009); Boyd, *CEO Duality*, *supra* note 183, at 304.

268. Tingle, *Best Practices*, *supra* note 164, at 315. Ryan Krause & Matthew Semadeni, *Last Dance or Second Chance? Firm Performance, CEO Career Horizon, and the Separation of Board Leadership Roles*, 35 STRATEGIC MGMT. J. 808 (2014). *See also*, Ryan Krause & Matthew Semadeni, *Apprentice, Departure, and Demotion: An Examination of Three Types of CEO-Board Chair Separation*, 56 ACAD. MGMT. J. 805 (2013); Olubunmi Faleye, *Does One Hat Fit All? The Case of Corporate Leadership Structure*, 11 J. MGMT. GOV. 239 (2007). *See also* Aiyesha Dey, Ellen Engel & Xiaohui Liu, *CEO and Board Chair Roles: To Split or Not to Split?*, 17 J. CORP. FIN. 1595 (2011).

markets, suppliers, strategy, and assets before providing an answer.[269] Where is the theory in their analysis?

2. Broad Measures of Good Governance

Another test of agency theory's ability to produce useful generalizations about corporate governance outcomes is to look at the various attempts to create an over-all index that measures multiple best practices suggested by the theory. It is possible that, whatever the problems of individual candidates for best practices, companies that generally conform to the recommendations of normative agency theory will outperform those that do not. Fortunately, over the past forty years, operating precisely on this assumption, academics, regulators, commercial services, and the media have created various schemes to measure corporate adherence to various best practices derived from what are understood to be the central insights of agency cost theory.

The empirical evidence around these attempts to measure or rank governance has been canvassed at length.[270] A vast body of research confirms that greater corporate adherence to these schemes does not predict better results. Looking first at commercial services, the largest and most recent study, correcting for methodological failures in earlier studies, found that the rating schemes of Institutional Shareholder Services, The Corporate Library, and another firm, now part of MSCI, failed to correlate with accounting restatements, class action lawsuits, return on assets, market-to-book ratio, and stock price performance.[271] The study concluded that "[t]hese governance ratings have either limited or no success in predicting firm performance or other outcomes of interest to shareholders."[272] In relation to various commercial ESG indices, there are at least six peer-reviewed academic studies that decompose the indices to examine the

269. The same is true of questions of shareholder power where investigators have found outcomes depend on institutional shareholders' investment strategy (*See* Bushee, *supra* note 75; Hoskisson et al, *supra* note 75);approach to governance issues: James A. Brickley, Ronald C. Lease & Clifford W. Smith Jr., *Ownership Structure and Voting on Anti-Takeover Amendments*, 20 J. FIN. ECON. 267 (1988); David Parthiban, Rahul Kochhar & Edward Levitas, *The Effect of Institutional Investors on the Level and Mix of CEO Compensation*, 41 ACAD. MGMT. J. 200 (1998); the importance of R&D to the company's strategy (*See, e.g.*, discussion at notes 165 and 247); or the existence of important corporate counter-parties: William Johnson et al., *The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms*, 117 J. FIN. ECON. 307 (2015) (finding that takeover defenses are deployed by IPO firms precisely when they have large customers, dependent suppliers, or strategic partners).

270. Tingle, *Can We Measure It*, *supra* note 13.

271. *See* Robert M. Daines, Ian D. Gow & David F. Larcker, *Rating the Ratings: How Good are Commercial Governance Ratings*, 98 J. FIN. ECON. 439, 443-44 (2010).

272. *Id.* at 460. *See also* Rob Bauer, Nadja Guenster & Roger Otten, *Empirical Evidence on Corporate Governance in Europe: The Effect on Stock Returns, Firm Value and Performance*, 5 J. ASSET MGMT. 91, 101 (2004) (Using Deminor's governance ratings of European firms the researchers found that market-based measures of performance were positive or neutral with respect to corporate governance, but actual operational results were negative when they looked at companies' net profit margin and return on equity).

"governance" aspects; all find "governance" to be unrelated to various measures of corporate performance.[273]

The two most prominent academic attempts to measure firms' overall adherence to agency cost theory's best practices are the G-Index and the E-Index.[274] Hundreds of academic papers have relied on these indices' supposed correlations with real corporate outcomes.[275] In relation to the G-Index, the initial results leading to the creation of the index were an artifact of the narrow evaluation period used.[276] In subsequent periods, highly-ranked firms underperformed lower-ranked firms.[277] Researchers also showed that causality ran in the opposite direction from that assumed by the G-Index,[278] and that the

273. Cristiana Manescu, *Stock Returns in Relation to Environmental, Social and Governance Performance: Mispricing or Compensation for Risk?*, 19 SUSTAINABLE DEV. 95 (2011) (Using the KLD dataset, the author concluded that: "[T]he corporate governance, diversity and environment scores had no statistically significant effects on risk-adjusted returns" at 111). *See also* Andrij Fetsun & Dirk Sohnholz, *A Quantitative Approach to Responsible Investment: Using a ESG-Multifactor Model to Improve Equity Portfolios* (Veritas Investment GmbH Working Paper No. 2, 2014), https://webcache.googleusercontent.com/search?q=cache:3WRoUop9UQ8J:https://www.fondsnieuws.nl/system/storage/serve/115040/00P_Dr_Fetsun_Dr_Soehnholz_A_Quantitative_Approach.pdf+&cd=1&hl=en&ct=clnk&gl=ca. The study gave two-thirds weighting to Sustainalytics' corporate governance scores and found that during the period 2009 to 2013, "[t]he ESG total score did neither [sic] lead to additional performance generation . . . nor to risk reduction in the estimated period of time" at 5. *See also* Dolf Diemont, Kyle Moore & Aloy Soppe, *The Downside of Being Responsible: Corporate Social Responsibility and Tail Risk*, 137 J. BUS. ETHICS 213, 224-25 (2016) (finding measures of corporate governance in ESG ratings to be unrelated to downside tail risk). Benjamin R. Auer & Frank Schuhmacher, *Do Socially (Ir)responsible Investments Pay? New Evidence from International ESG Data*, 59 Q. REV. ECON. FIN. 51, 61 (2016) (Using Sustainalytics' ESG ratings the study found that governance ratings have either no material impact on performance or, in some circumstances, a negative relationship to performance); Meir Statman & Denys Glushkov, *The Wages of Social Responsibility*, 65 FIN. ANALYSTS 33 (2009) (finding the advantage of tilting-towards high-scoring firms is largely offset by the disadvantages of excluding low-scoring firms and proposing a different approach to portfolio composition); Stefano Grassi, Marco Nicolosi & Elena Stanghellini, *Item Response Models to Measure Corporate Social Responsibility*, 24 J. APPLIED FIN. ECON. 1449 (2014); *But see* Philipp Schreck, *Reviewing the Business Case for Corporate Social Responsibility: New Evidence and Analysis*, 103 J. BUS. ETHICS 167 (2011) (discussing the issues of endogeneity in the research). Using ESG ratings from oekom research AG, the author found a positive association between corporate governance and equity-market measures of performance but fails to find the expected evidence the former causes the latter, possibly as a result of limitations in the dataset.

274. *See* Gompers, Ishii & Metrick, *supra* note 58; Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783, 784-87 (2009).

275. Lucian A Bebchuk, Alma Cohen & Allen Ferrell, *Links to 1002 studies that Use the Entrenchment Index* (July 8, 2020), http://www.law.harvard.edu/faculty/bebchuk/studies.shtml.

276. *See* John E. Core, Wayne R. Guay & Tjomme O. Rusticus, *Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations*, 61 J. FIN. 655, 683 (2006) (finding that "adding these 4 years to the original sample reduces the observed abnormal returns by over one third and reduces their significance for the 1990-2003 period" and found as well that the excess returns appear to be tied to technology firms).

277. *Id.*

278. *See* Kenneth Lehn, Sukesh Patro & Mengxin Zhao, *Governance Indexes and Valuation Multiples: Which Causes Which?*, 13 J. CORP. FIN. 907, 908 (2007).

index failed to distinguish firms that went on to have major scandals from their peers.[279]

For its part, the E-Index's initial results appear to be the effect of the industry-composition of the high-ranked and low-ranked companies.[280] Subsequent research suggests the index is not correlated with future performance.[281] Amusingly, the E-Index (which supposedly measures the "entrenchment" of corporate officers), does not even successfully predict, the likelihood a board will terminate underperforming managers.[282]

There are lesser known attempts by academics to rank firms based on a wide range of governance best practices, but as one survey of the literature observed, these studies "[have] not yielded much evidence that these 'usual suspects' have any meaningful connection to firm performance."[283] Indeed, a meta-analysis of over one hundred studies of CEO roles, board structure, board size, and director shareholdings failed to find any predictable relationship between best practices in these areas and investment outcomes.[284]

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279. Aaron K. Chatterji & David I. Levine, *Imitate or Differentiate? Evaluating the Validity of Corporate Social Responsibility Ratings*, (UC Berkeley: Center for Responsible Business Working Paper Series, 2008), https://escholarship.org/uc/item/3sz7k7jc.

280. *See* Shane A. Johnson, Theodore C. Moorman & Sorin Sorescu, *A Reexamination of Corporate Governance and Equity Prices*, 22 REV. FIN. STUD. 4753, 4784-85 (2009). *But see* Xavier Giroud & Holger M. Mueller, *Corporate Governance, Product Market Competition, and Equity Prices*, 66 J. FIN. 563, 578-79 (2011) (arguing that the E-Index is predictive of performance if a larger dataset is used, though only for companies in non-competitive industries).

281. See Shane A. Johnson, Theodore C. Moorman & Sorin Sorescu, *A Reexamination of Corporate Governance and Equity Prices*, 22 REV. FIN. STUD. 4753 (2009). But see Xavier Giroud & Holger M. Mueller, *Corporate Governance, Product Market Competition, and Equity Prices*, 66 J. FIN. 563, 578-79 (2011) (arguing that the E-Index is predictive of performance if a larger dataset is used, though only for companies in non-competitive industries). See Bhagat & Bolton, *supra* note 168 (finding some correlation between the two indices and operating performance, but no correlation at all with future stock market performance.); and David F. Larcker, Peter C. Reiss & Youfei Xiao, *Corporate Governance Data and Measures Revisited*, (Rock Centre for Corporate Governance Working Paper No 211, 2015) (after correcting for measurement errors in the underlying data, concluded neither was associated with statistically significant investment outcomes).

See e.g Dean Diavatopoulos & Andy Fodor, *Does Corporate Governance Matter for Equity Returns?*, 16 J. ACCT. FIN. 39 (2016) (finding that the predictive aspects of the G-Index and E-Index disappear when looking at different time periods or monthly returns); Lucian A. Bebchuk, Alma Cohen & Charles C.Y. Wang, *Learning and the Disappearing Association Between Governance and Returns*, 108 J. FIN. ECON. 323 (2013) (finding that firm performance is unrelated to E-Index or G-Index scores for the time period between 2000 to 2008); DAVID F. LARCKER & BRIAN TAYAN, CORPORATE GOVERNANCE MATTERS: A CLOSER LOOK AT ORGANIZATIONAL CHOICES AND THEIR CONSEQUENCES (2011) (Larcker and Tayan summarize the state of research on the two indices as follows: "Taken as a whole, definitive conclusions have not been reached about the predictive ability of an index composed of mostly anti-takeover provisions on future firm performance" at 453). See Bhagat & Bolton, *supra* note 168. See David F. Larcker, Peter C. Reiss & Youfei Xiao, *Corporate Governance Data and Measures Revisited*, (Rock Centre for Corporate Governance Working Paper No 211, 2015).

282. *See* Bhagat & Bolton, *supra* note 168, at 271.

283. Yangnin Kim & Albert A. Cannella Jr., *Toward a Social Capital Theory of Director Selection*, 16 CORP. GOV. 282, 282 (2008).

284. *See* David Finegold, George S. Benson & David Hecht, *Corporate Boards and Company Performance: Review of Research in Light of Recent Reforms*, 15 CORP. GOV. 865C (2007). *See also* Sydney Finkelstein & Ann C. Mooney, *Not the Usual Suspects: How to Use Board Process to Make*

Canada and the United Kingdom have adopted "comply or explain" regimes, allowing evaluation of the relative performance of high-complying firms with those adopting fewer of the recommended practices. Six studies all generally failed to find meaningful differences between the two types of companies.[285]

3. Summary

There is little evidence that corporate best practices generalized from agency cost theory, either individually or in aggregate, produce the expected corporate outcomes.[286] Even if we use a firm's broad-based adherence to a range of best practices as a general measure of its dedication to managing agency costs, we do not see the outcomes the theory predicts. Surveying the research, one scholar observes, "agency theory, which underlies the entire edifice . . . has little explanatory or predictive power."[287]

Of course, the most comprehensive way of imposing governance best practices across all types of companies is government or agency regulation. What happens when corporate governance practices are imposed on all companies at once? A study on precisely this question concluded, "collectively, we find robust evidence of a negative stock price reaction for firms whose governance practices would be most altered by the proposed regulations."[288] This negative reaction occurred in the context of many different types of regulation, but it was particularly pronounced in relation to regulatory actions that have the effect of

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Boards Better, 17 ACAD. MGMT. EXECUTIVE 101 (2003) (finding no way to distinguish high and low performing companies on the basis of a panel of corporate governance best practices).

285. Amama Shaukat & Carol Padgett, *The UK Code of Corporate Governance: Link Between Compliance and Firm Performance* 27 (ICMA Centre Finance Discussion Paper No. DP2005-17, 2005) (suggesting that compliance may not improve a firm's operating performance however it does improve investors' perception of the governance of companies); Amama Shabbir, *To Comply or Not to Comply: Evidence on Changes and Factors Associated with the Changes in Compliance with the UK Code of Corporate Governance* (Cranfield University Research Paper No. 5, 2008), https://dspace.lib.cranfield.ac.uk/bitstream/handle/1826/2482/RP5-08.pdf?sequence=1&isAllowed=y (finding weak evidence the UK Combined Code boosts operating performance); Nikos Vafeas & Elena Theodorou, *The Relationship Between Board Structure and Firm Performance in the UK*, 30 BRIT. ACCT. REV. 383 (1998) (finding no significant link between board structure and firm performance in a study of data from 250 publicly traded firms in the UK); Charlie Weir, David Laing & Phillip J. McKnight, *Internal and External Governance Mechanisms: Their Impact on the Performance of Large UK Public Companies*, 29 J. BUS. FIN. ACCT. 579, at 601, 603 (2002) (finding a weak relationship between the internal governance relationships and performance and little evidence that with firms in the top and bottom performance deciles have different internal governance characteristics.); Fodil Adjaoud, Daniel Zeghal & Syed Andaleeb, *The Effect of Board's Quality on Performance: A Study of Canadian Firms*, 15 CORP. GOV. 623 (2007) (finding no significant relationship between corporate governance and performance using traditional performance measures); Lorne N. Switzer & Catherine Kelly, *Corporate Governance Mechanisms and the Performance of Small-Cap Firms in Canada*, 2 INT. J. BUSINESS GOVERNANCE AND ETHICS, 294 (2006).

286. Tingle, *Can We Measure It?*, *supra* note 13. *See also* Sumantra Ghoshal, *Bad Management Theories Are Destroying Good Management Practices*, 4 ACAD. MGMT. LEARNING & EDUC. 75 (2005).

287. *Id.* at 80.

288. David F. Larcker, Gaizka Ormazabal & Daniel J. Taylor, *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431, 433 (2011).

increasing shareholder power, such as providing enhanced proxy access or reducing the power of staggered boards.[289]

F. Hypothesis 6: Corporate Managers Act in Ways that Place their Personal Interests Above Those of the Firm

As discussed earlier, one of the reasons firms remained a "black box" until the rise of agency theory is that it was widely believed corporate managers acted in the best interests of their firms. As late as 1972, Eugene Fama and Merton Miller believed the empirical evidence strongly suggested this.[290] Agency cost theory's insight (if it was such a thing) was to overturn this consensus and claim that, "if both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal."[291] This gives rise to what Oliver Williamson, another early agency theory scholar famously termed "opportunistic behavior."[292]

However, throughout agency cost theory's ascendency, there have been numerous scholars who have asked whether the realities of running a corporation operating in commercial markets actually provide the opportunities for the slack and diversion assumed by agency cost theory.

1. The Failures of Previous Hypotheses

The failure of the previous hypotheses serves as strong evidence that agency cost theory's foundational assumption of unfaithful agents is wrong. Every effort made over forty years to monitor, control, and properly incentivize corporate executives has made little to no difference in how they manage their businesses. The simplest explanation for these results is that managers do not engage in much slack and diversion, even when they are not subject to the various structures designed to make them faithful stewards of the shareholders.

Even where we would most expect opportunistic behavior to occur, managers act as faithful stewards of their firms. Managers of companies with dual-class shares distribute more cash to shareholders and financially outperform their peers. Classified boards protected from takeovers perform just as well or better than peers, as well as paying and firing their CEOs in precisely the same ways as unprotected boards. "Entrenched" managers with boards prepared to violate the cannons of good governance, as measured by the E-index and other governance rating schemes, generate superior returns, and those managers are disciplined by those boards in exactly the same ways as other firms. Nothing in

289. Id.

290. *See supra* note 9.

291. Jensen & Meckling, *supra* note 1, at 308. *See also* Eric Noreen, *The Economics of Ethics: A New Perspective on Agency Theory*, 13 ACCT., ORGS., AND SOC. 359 (1988).

292. OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES, ANALYSIS AND ANTI-TRUST IMPLICATIONS: A STUDY IN THE ECONOMICS OF INTERNAL ORGANIZATION (1975).

the empirical literature considered in this paper would surprise Fama and Miller in 1972.

2. Fiduciary Duties

Agency cost theory places the fiduciary duty of loyalty at the heart of corporate law. After all, it is the fiduciary duty that instantiates the obligation of corporate agents to ensure their personal interests do not interfere with their obligations to their principals. Agency theory is about the corporate fiduciary duty.

There are several bodies of empirical research regarding the impact of changes to the corporate fiduciary duty. The first arose in connection with state legislatures adopting constituency statutes in the 1980s and 1990s. These statutes gave the managers of companies incorporated in those states permission, or in a few cases a duty, to consider a range of stakeholders when making corporate decisions.[293] This change was widely expected to increase agency costs, as corporate fiduciaries were no longer legally obliged to maximize shareholder returns.[294] In particular, by increasing the number of objects of the fiduciary duty, academics using agency cost theory predicted major increases in managerial self-dealing and shirking, as virtually any corporate action could be defended as advancing the interest of some constituency.[295]

However, the empirical literature has clearly found that when provided with considerable freedom to engage in the behaviors agency cost theory assumes probable, managers remain faithful stewards of the firm, including respecting the interests of shareholders.[296] First, managers do not take advantage of

293. Andrew Keay, *Moving Towards Stakeholderism - Constituency Statutes, Enlightened Shareholder Value, and More: Much Ado About Little*, 22 EUR. BUS. L. REV. 1, 8 (2011).

294. *See* Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 172 (1992) (predicting that stakeholder conceptions of fiduciary duties would "raise the cost of equity capital and impair the market's allocative efficiency").

295. *See* Jonathan R. Macey, *An Economic Analysis of The Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 32 (1991-1992) ("the primary beneficiaries of nonshareholder constituency statutes are incumbent managers, who can justify virtually any decision they make on the grounds that it benefits *some* constituency of the firm . . . these statutes . . . effect alarming changes in officer and director accountability to shareholders"); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 418 (1991); Oliver Hart, *An Economist's View of Fiduciary Duty,* 43 U. TORONTO L.J. 299, 303 (1993). *See also* ABA Comm. On Corp. Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2269 (1990) ("[t]he confusion of…trying to…require directors to balance the interests of various constituencies without according primacy to shareholder interests, would be profoundly troubling"); Tingle & Spackman, *Do Fiduciary Duties Matter*, *supra* note 78, at 296-97 (discussing academic predictions that the Canadian transformation to a stakeholder model of fiduciary duties would significantly increase agency costs).

296. Keay, *Moving Towards Stakeholderism*, *supra* note 292, at 17. *See also* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 463 (2006) ("While, at first glance, constituency statutes seem quite promising for the social responsibility theorist, upon closer examination, they are rather disappointing. At least with the benefit of hindsight, it seems clear that constituency statutes are not very significant").

constituency statutes by transferring into more management-friendly jurisdictions.[297] Second, constituency statutes do not adversely impact the likelihood a company in that jurisdiction will be acquired.[298] Since the vast majority of takeovers are friendly, this is strong evidence the directors continue to respect the interests of shareholders, even when their legal duties to do so have been relaxed. Third, shareholders show little sign they expect management behavior to change when the fiduciary duty is altered to remove shareholders from their privileged position.[299] Finally, event studies find that adopting constituency statutes either produced no effect on shareholder wealth or a minimal impact (0.33 percent) that quickly dissipated.[300]

Similar results emerge in relation to the more than 1,500 companies adopting corporate opportunity waivers in the last two decades. These waivers essentially relieve directors of their duty of undivided loyalty to the company.[301] Researchers have found no evidence that companies use these waivers to divert value from investors.[302] Indeed, grants of these waivers are accompanied by small, but consistent, positive abnormal stock returns.[303] The managers asking for these waivers also cannot be characterized as bad actors looking to take advantage of a chance to escape their legal obligations, but as officers of well-run companies that have "an established record of delivering attractive returns to their capital investors."[304]

The final source of empirical evidence about corporate fiduciary duties arises from a 2008 decision of the Canadian Supreme Court to unilaterally and instantly changed the focus of the fiduciary duty from shareholders to stakeholders.[305] This decision produced many expressions of concern from

297. Christopher Geczy et al., *Institutional Investing When Shareholders Are Not Supreme*, 5 HARV. BUS. L. REV. 73, 119 (2015) (finding, in a survey of over 14,000 firms from 1980 to 2005, that "only 1% of firms switched out of a constituency state to a nonconstituency state, and only 0.1% switched out of a nonconstituency state into a constituency state").

298. Matthew D. Cain, Stephen B. McKeon & Steven Davidoff Solomon, *Do Takeover Laws Matter? Evidence from Five Decades of Hostile Takeovers*, 124 J. FIN. ECON. 464, 476 (2017).

299. Geczy et al., *supra* note 296, at 127 (looking specifically at High Fiduciary Duty Investors, such as pension fund administrators, which owe the most onerous duties to their beneficiaries and might therefore be expected to have the strongest bias toward the norm of shareholder wealth maximization).

300. Roberta Romano, *Comment: What Is the Value of Other Constituency Statutes to Shareholders?*, 43
U.T.L.J. 533, 542 (1993) ("Is value added or subtracted by other constituency statutes? The data identify no significant effect on investor wealth"); John C. Alexander, Michael F. Spivey & M. Wayne Marr, *Nonshareholder Constituency Statutes and Shareholder Wealth: A Note,* 21 J. BANKING & FIN. 417, 426 (1997).

301. Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers,* 117 COLUM. L. REV. 1075 (2017) .

302. *Id.* at 40.

303. *Id*.

304. Id.

305. *BCE Inc. v 1976 Debentureholders*, [2008] 3 S.C.R. 560; Tingle & Spackman, *Do Fiduciary Duties Matter, supra* note 78.

Canadian corporate law scholars using agency theory.[306] They correctly pointed out—as American scholars had observed in relation to constituency statutes—that a duty to everybody is effectively a duty to nobody. However, like constituency statutes, it turned out that the Supreme Court's adoption of a stakeholder duty had little to no impact on corporate behavior, which remained focused on maximizing profits and shareholder value. Takeover premiums increased, the price-earnings ratio of Canadian firms increased, and the discount for new equity declined.[307] All of these trends are the opposite of what agency theory predicts if managers really are prone to disloyalty.

3. Direct Evidence of Managerial Motivation

Studies that investigate whether managers are motivated to be bad agents are surprisingly rare. As a recent paper noted, " . . . the primacy of self-interest is also an empirical claim . . . Direct testing of this assumption is notably absent in our literature, even though existing literature in accounting and elsewhere indirectly raises significant questions about the validity of the assumption of strictly self-interested behavior."[308] The authors go on to cite several studies that found managerial self-interest was constrained by ethical considerations[309] and considerations of fairness to others.[310] There is evidence visible throughout the vast literature on corporate governance, that managers care about shareholder value and sacrifice to achieve it.[311] Indeed, revolutionary changes in corporate governance–restructuring boards and increasing the power of shareholders have often been implemented by corporate managers themselves.

306. Id.

307. Tingle & Spackman, *Do Fiduciary Duties Matter*, *supra* note 78.

308. Jeffrey R. Cohen & Lori L. Holder-Webb, *Rethinking the Influence of Agency Theory in the Accounting Academy*, 21 ISSUES IN ACCT. EDUC. 17, 23 (2006).

309. Douglas Stevens, *The Effect of Reputation and Ethics on Budgetary Slack*, 14 J. MGMT. ACCT. RSCH. 153 (2002); John H. Evans et al., *Honesty in Managerial Reporting*, 76 ACCT. REV. 537 (2001) (raising questions about the validity of the assumption of strictly self-interested behaviour). Robert W. Rutledge & Khondkar E. Karim, *The Influence of Self-Interest and Ethical Considerations on Managers' Evaluation Judgments*, 24 ACCT. ORG. SOC. 173, 182 (1999) (finding find that the ''contention from agency theory that individuals make economic decisions based solely on their self-interest is not supported by this study. Rather, managerial self-interest may be constrained by ethical conditions, which casts much doubt on the agency theory assumption that behavior is motivated solely by self-interest" at 181-82); Patrice Gelinas & Lisa Baillargeon, *CEO Perquisites in Canada, 1971-2008: Certainly Not "Pure" Managerial Excess*, 13 INT'L J. BUS. & MGMT. 105, 109 (2018) (finding the evolution of executive perks cannot be explained as an agency problem).

310. Lori Holder-Webb et al., Presentation at the Am. Acct. Ass'n Annual Meeting: *The Effect of Perceived Fairness on the Agency Problem*, (2004); Theresa Libby, *Referent Cognitions and Budgetary Fairness: A Research Note*, 13 J. ACCT. RSCH. 91 (2001) (finding that when many individuals make accounting-based decisions, their consideration of fairness exerts a significant effect on their predilection to act in their self-interest).

311. *See, e.g.*, Cunat, Lu & Wu, *supra* note 59 at 8 (finding in the context of disputes over majority voting, evidence that "managers do care about shareholder value…"); Douglas Cummings, et al., *For Whom (and For When) is the Firm Governed? The Effect of Changes in Corporate Fiduciary Duties on Tax Strategies and Earnings Management*, 27 EUR. FIN. MGMT. 775 (2021) (finding directors once freed of the duty to pursue shareholder interests, nevertheless appear still motivated to do so).

When managers receive cash windfalls, such as those provided by recent American corporate tax reforms, scholars find that managers return the money to shareholders rather than wasting or diverting it.[312] As well, when directors obtain some measure of freedom from shareholder oversight, investments are put into things like R&D, not compensation.[313] As one scholar notes, "[d]espite its influence, more than 40 years of active research have yet to uncover any good evidence that managers are systematically disloyal."[314]

When boards are asked about their firms' dedication to maximizing value, they clearly believe they are faithful agents.[315] This is why support for various agency theory-inflected best practices is generally dismissed by corporate directors as unimportant.[316] As we have seen, this cannot be dismissed as a manifestation of self-interest; the preponderance of evidence is that directors are correct in their assessment of the merits of these practices. Could they also be correct in their assessment that the directors and managers they work with closely over many years are faithful agents?

4. Summary

There are two ways to understand the evidence that managerial behavior is not characterized by negligence and profusion. One is to conclude that the "plain-

312. Dhammika Dharmapala, C. Fritz Foley & Kristin J. Forbes, *Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act*, 66 J. FIN. 753 (2011) (looking at behavior following passage of the 2004 Homeland Investment Act and finding strong evidence that serious agency problems do not widely affect U.S. multinationals).

313. Caroline Flammer & Aleksandra J. Kacperczyk, *The Impact of Stakeholder Orientation on Innovation: Evidence from a Natural Experiment*, 62 MGMT. SCI. 1982 (2014) (finding a legal move to constituency statutes causes "significant" increases in the number of patents and citations per patent.). *See also* discussion *supra* at notes 71, 105, 122, 165, 209 and 247.

314. Heaton, *supra* note 8, at 214, 216 ("The notion of corporate directors and managers looking for every self-serving opportunity to shirk their duties…strikes directors, officers, and their professional advisors like bankers and lawyers as flatly untrue.").

315. Heaton, *supra* note 8.

316. *See, e.g.*, PricewaterhouseCooper, *What Matters in The Boardroom? Director and Investor Views on Trends Shaping Governance and the Board of the Future* (2014), https://www.pwc.pl/pl/pdf/forum-rad-nadzorczych/pwc-what-matters-in-the-boardroom-director-investor-views.pdf (finding corporate best practices failed to get the support of even 25% of the directors surveyed.); *Governance Insights Center: PwC's 2016 Annual Corporate Directors Survey* (Oct. 2016) https://www.pwc.com/us/en/corporate-governance/annual-corporate-directors-survey/assets/pwc-2016-annual-corporate-directors-survey.pdf (59% of directors ranked diversity considerations not very important; 66% expressing some concern about proxy access; 65% don't believe in mandatory retirement policies and 90% oppose term limits; only small minorities have a high regard for dialogue with shareholders; 96% of directors believe activists are too focused on the short-term; 93% believe proxy advisors have too much power; 57% feel shareholders have too much say in governance; less than half of the directors indicated their boards acted on their annual board self-evaluations; a majority don't believe risk committees are useful; 72% don't believe say-on-pay has reduced executive compensation levels); Tingle, *Best Pay Practices*, *supra* note 144, at 396 (explaining that executives don't believe pay practices make a difference); Silvia Ascarelli, *Corporate Europe Is Skeptical About Tougher Governance Codes*, THE WALL STREET JOURNAL (Oct. 7, 2004), https://www.wsj.com/articles/SB109710683845238701; Beckey Bright, *Investors Are Skeptical of Success of Sarbanes-Oxley, Poll Finds*, THE WALL STREET JOURNAL Oct. 14, 2005), https://www.wsj.com/articles/SB112912865268466716.

vanilla constraints of corporate law are just too powerful to leave much to do for debt, large shareholders, and takeovers in controlling intentional managerial disloyalty."[317] I have argued elsewhere that a much more important constraint on opportunistic behavior are the disciplining forces of market competition.[318] The second way to explain the evidence is to emphasize the ways that behavioural economics has repeatedly found pro-social behaviour in the participants of its various experiments.[319] Many scientists conclude, along with James Q. Wilson, "[o]n balance, I think other-regarding features of human nature outweigh the self-regarding ones."[320]

IV. CONCLUSION

The hold of agency cost theory on the minds of the various groups that concern themselves with the governance of corporations is extraordinary. We have seen investors misprice shares,[321] managers adopt pay and governance practices they do not consider advantageous,[322] and academics continue to test predictions that have long since been proven false. Summarizing the vast body of research on board independence and firm performance, one group of scholars noted: "[a]t least two levels of consistency are present in all of these reviews and discussions. First, they provide no evidence of systemic relationships between these variables. Second, most authors have not forsaken their commitment to affirm these relationships."[323]

What is particularly striking is the disconnect between corporate governance practices and the empirical evidence. Except for the work on activist shareholders and staggered boards, most of the conclusions drawn in this article were available to an informed reader decades ago. However, agency cost theory, in all its seductive simplicity, has always trumped the facts. For example, the rising use of equity incentives and pay-for-performance schemes between 1990 and 2010 was accompanied by constant expressions of concern from researchers

317. Heaton, *supra* note 8, at 215.

318. Bryce C. Tingle, *Returning Markets to the Center of Corporate Law*, 48 J. Corp. Law. 663 (2023).

319. *See, e.g.*, Richard Thaler & Colin Farrell Camerer, *Ultimatums, Dictators and Manners*, 9 J. ECON. PERSP. 209 (1995) (finding participants in the well-known "ultimatum game" do not behave as economic maximizers but seem to adhere to norms of fairness); LYNN STOUT, CULTIVATING CONSCIENCE: HOW GOOD LAWS MAKE GOOD PEOPLE (2010) [hereinafter STOUT, CULTIVATING CONSCIENCE].

320. Quoted in ROBERT H. NELSON, ECONOMICS AS RELIGION: FROM SAMUELSON TO CHICAGO AND BEYOND 8 (2001). *See also* JAMES Q. WILSON, THE MORAL SENSE (1993); Amartya Sen, *Forward* in ECONOMICS, VALUES, AND ORGANIZATION (Avner Ben-Ner & Louis Putterman, eds.,1998) ("We should not fall into the trap of presuming that the assumption of pure self-interest is, in any sense, more elementary than assuming other values. Moral or social concerns can be just as basic or elementary" at viii); DANIEL BATSON, ALTRUISM IN HUMANS (2011) (summarizing experimental evidence for altruism); AVNER BEN-NER AND LOUIS PUTTERMAN, ECONOMICS, VALUES AND ORGANIZATIONS 7 (1998). *See also* STOUT, CULTIVATING CONSCIENCE, supra note 315.

321. Reddy, *supra* note, 127. *See also* Tingle, *Two Stories*, *supra* note 111, at 39.

322. *See supra* text accompanying note 33.

323. Dalton et al., *Fundamental Agency Problem*, *supra* note 15, at 11.

examining the evidence. In the beginning of the era of agency cost theory's ascendency in 1980, one scholar observed that the empirical evidence on the relationship between executive equity holdings and firm performance was "quite mixed."[324] By 1986, another scholar noted that "no consensus has developed" among empirical researchers about the impact of managerial exposure to equity. In 1994, a scholar noted, "the results of the studies are inconclusive."[325] In 1995, two other researchers noted there was a "singular lack of consistency in the empirical results reported."[326] In 1999, one of the leading researchers in the area of executive compensation, Kevin Murphy observed, "[u]nfortunately, although there is a plethora of evidence on dysfunctional consequences of poorly designed pay programs, there is surprisingly little direct evidence that higher pay-performance sensitivities lead to higher stock-price performance."[327] Yet, during this period, the use of equity and pay-for-performance schemes went from being extremely rare[328] to universal.[329]

The activities of regulators follow this pattern as well. During the era of the Sarbanes-Oxley reforms, Roberta Romano was able to marshal abundant evidence that pre-existing empirical research contradicted the proposed regulatory changes.[330] Stephen Bainbridge did the same during the era we were introducing the Dodd-Frank reforms.[331] When a court struck down the SEC's proposed proxy access rules, the judge pointed to multiple prior studies suggesting it was a bad idea.[332] However, the pull of agency cost theory's normative program has always trumped what was known about the real world.

When lawyers and businesspeople first encounter the corporate governance world, it is disorienting, as it has very little to do with the preoccupations of directors and managers. After all, most corporate actors' attention and anxiety are focused on the firm's competitive activities in various markets, and discussions of corporate governance best practices are usually entirely unrelated to this performance, outside of some rhetorical flourishes.[333] Encountering the

324. James L. Bothwell, *Profitability, Risk, and the Separation of Ownership from Control*, 28 J. INDUS. ECON. 303, 304 (1980).

325. Helen Short, *Ownership, Control, Financial Structure and the Performance of Firms*, 8 J. ECON. SURV. 203, 206 (1994).

326. Kenneth J. Rediker & Anju Seth, *Boards of Directors and Substitution Effects of Alternative Governance Mechanisms*, 16 STRATEGIC MGMT. J. 85 at 86 (1995).

327. Murphy, *Executive Compensation*, *supra* note 143, at 2539.

328. Frydman & Jenter, *supra* note 143 (in the U.S., salaries and bonuses comprised 93% of CEO compensation during the 1950s and 87% in the 1960s at 80); The Kay Report, *supra* note 230 ("bonuses and similar rewards for senior executives in UK companies were relatively unusual until the 1980s, when share option schemes became increasingly common" at 77)

329. Tingle, *Best Pay Practices*, *supra* note 144, at 395, 410.

330. Romano, *Quack*, *supra* note 163.

331. Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2011).

332. *Business Roundtable v SEC*, 647 F (3d) 1144 (DC Cir App 2011).

333. *See* Tingle, *supra* note 320.

empirical literature is similarly disorienting. At first one feels, like Charlie Brown, that there is a chance a governance best practice will succeed in kicking the football through the uprights. As one gets deeper, one begins to feel a certain inevitability that the ball will be pulled away at the last minute. Eventually, one begins to doubt the existence of the football. The final stage is when one realizes what is going on is a game of soccer.