Principal Costs: A New Theory for Corporate Law and Governance


By Zohar Goshen and Richard Squire May 8, 2017

For the last 40 years, the problem of managerial agency costs—corporate managers shirking duties and diverting resources—has dominated the study of corporate law and governance. Many scholars treat the reduction of agency costs as the essential function of corporate law and governance. To reduce agency costs, these scholars would mandate corporate governance arrangements that empower shareholders to hold managers accountable, such as majority voting and proxy access. And they would ban arrangements that disempower shareholders, such as staggered boards and dual-class shares. Similarly, they support hostile takeovers and hedge fund activism to combat management entrenchment and reduce agency costs. To support the claimed benefits of shareholder empowerment, these scholars also offer a wide range of empirical studies measuring the effects of governance quality on firms' value. Following these scholars, a bourgeoning "governance industry" of activists and proxy advisors is promoting "good" corporate governance metrics and indices. Indeed, to agency-costs essentialists, the reduction of agency costs is an unalloyed good, toward which all aspects of corporate law and governance should be directed. However, these scholars disregard the costs that shareholders avoid by delegating control to managers and voluntarily restricting their own control rights.

In an essay just published in the *Columbia Law Review*, we offer a new theory of corporate governance that we term *principal-cost theory*. Our theory challenges the theoretical foundations of the agency-cost essentialists, the existence of a uniform "good" corporate governance, the validity of the empirical studies supporting their claims, and the wisdom of their one-size-fits-all policy recommendations.

We argue that each firm's optimal governance structure minimizes the sum of *principal costs*, produced when investors exercise control, and *agent costs*, produced when managers exercise control. Both principal costs and agent costs can arise from honest mistakes (which generate *competence costs*) and from disloyal conduct (which generate *conflict costs*). When investors exercise control, they make mistakes due to a lack of expertise, information, or talent, thereby generating principal competence costs. To avoid such costs, they delegate control to more competent managers. But delegation separates ownership from control, leading to agent conflict costs*, and also* to principal conflict costs to the extent that principals retain the power to hold managers accountable. Finally, managers themselves can make honest mistakes, generating agent competence costs. Thus, the allocation of control rights in a governance structure is aimed at minimizing total *control costs* (i.e., the sum of all four categories).

Agent costs and principal costs are substitutes for each other: Any reallocation of control rights between investors and managers decreases one type of cost but increases the other. The rate of substitution is firm-specific, driven by factors such as business strategy, industry, and the personal characteristics of the key parties. Therefore, each firm has a distinct division of control rights that minimizes total control costs. Because the cost-minimizing division varies by firm, the optimal governance structure does as well. The implication is that law's proper role is to allow firms to select from a wide range of governance structures, rather than mandating some structures and banning others.

Agency-cost essentialists focus on one of the four categories of control cost we have identified: agent conflict costs. They downplay agent competence costs, and more important, they largely disregard both types of principal cost. Yet principal costs are more fundamental than agent costs, as the goal of reducing them is the reason that investors delegate control to managers, generating the conflict costs that preoccupy agency-cost scholars. A firm that seeks to maximize total returns will weigh principal costs against agent costs when deciding how much control to allocate to managers and how much to restrict the power of investors to hold the managers accountable. When a firm has multiple investors, principal costs arise primarily from conflicting interests and the duplicative efforts and coordination problems entailed by joint decision-making. But even if a firm has just one investor, principal costs—in particular, principal competence costs—will arise whenever the investor makes honest mistakes due to a lack of talent, information, or expertise.

The firm-specific nature of the tradeoff between principal costs and agent costs is the reason that firms adopt a wide variety of governance structures, each of which offers a different division of control between investors and managers. At one end of the spectrum is the dual-class share structure, which gives controlling owner-managers complete and incontestable control. Firms that adopt this structure minimize potential principal costs but run the risk of high agent costs. At the opposite extreme—rarely seen except in sole proprietorships and small partnerships—are firms in which the equity investors retain full control over the selection and development of the firm's business strategy. Such firms minimize potential agent costs but run the risk of high principal costs. Toward the middle of the spectrum is the most common governance structure in American public corporations: dispersed share ownership. Managers of firms with that structure exercise a large degree of control, which can generate significant agent costs. But the managers' control can be contested through a hostile tender offer or shareholder activism, the prospect of which keeps agent costs in check. Because, however, hostile raiders and activist hedge funds sometimes mistakenly target firms whose managers are in fact effective, this ownership structure can also generate significant principal costs.

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

These contributions make salient two aspects of the corporate-governance problem that scholars who fixate on agency costs neglect. First, a firm will suffer control costs regardless of who exercises control—investors or managers. Second, because the impact of a given governance structure on control costs is firm-specific, there is no particular governance structure that can be described as intrinsically good, bad, welfare-enhancing, or inefficient.

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

A second test of a theory is the wisdom of its policy prescriptions. Agency-cost essentialists advocate shifting more control to shareholders, while a smaller group of scholars—sometimes referred to as the director-supremacy school—wants to insulate corporate managers from control contests. Principal-cost theory suggests that both policy prescriptions are unwise, as both would treat all firms the same. Because, as principal-cost theory demonstrates, the governance structure that minimizes control costs varies by firm, lawmakers—including courts, regulators, and legislators—should avoid one-size-fits-all solutions. Rather, in the absence of clear market failures, they should presume the efficiency of each firm's chosen governance structure. And they should seek to grow, rather than shrink, the menu of governance-structure options.

This post comes to us from Professor Zohar Goshen at Columbia Law School and Professor Richard Squire at Fordham University School of Law. It is based on their recent article, "Principal Costs: A New Theory for Corporate Law and Governance," available here.