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MANAGERS' DISCRETION AND INVESTORS' WELFARE:
THEORIES AND EVIDENCE

FRANK H. EASTERBROOK*

For the last fifty years, public discussion of corporations and public policy toward corporations have been dominated by the vision of Adolph Berle and Gardiner Means.¹ Berle and Means portrayed managers as out of control. Berle and Means attributed this to the "separation of ownership and control"—another term for a division of labor in which some people specialize in risk-bearing through investment, while others specialize in management. When thousands of people hold investment interests in a firm, none has much incentive to oversee the managers. Each investor, rightly thinking that his efforts can do little, will be passive. The investors are scattered, uncoordinated, and helpless. They have ownership without control; the managers have control without ownership.

Berle and Means also thought that corporations were growing in size and influence. Their great size would give them power over consumers; they could charge "administered prices" without regard to competitive forces. The managers, responsible to no one, could exploit investors and consumers alike.

Berle and Means welcomed the emerging class of managerial technocrats. They saw specialist managers as a way of making corporations more efficient producers. They therefore proposed not control of managers by investors, but control of corporations by government. In the Berle and Means vision, technocratic managers would run the firms, making goods and services in ever-increasing quantities. Investors would be paid enough to keep them satisfied. Public regulators would direct corporate policy in the interest of society as a whole.

The goal of public control animated many of those who wrote and adopted the Securities Act of 1933 and the Securities Exchange Act of 1934. William O. Douglas worked to obtain for the SEC the power to make important decisions for the firms. Those who agreed

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1. A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

with Berle and Means stopped with half-a-loaf during the New Deal, however. The principal securities acts required disclosure yet avoided substantive regulation. The regulatory agencies were confined to overseeing particular industries, such as transportation and communications, rather than corporations in general.

Even the incomplete victories of the Berle and Means approach have come under pressure. Regulation is increasingly seen as the consequence of interest-group politics, in which the regulated firms themselves obtain regulation in order to forestall competition. A wave of deregulation in transportation, communications, and even the securities exchanges has led to new entry, lower prices, and pressure for still more deregulation.

The Berle and Means vision nevertheless lingers in the rhetoric of regulators, academics, and even corporate officials. All continue to emphasize the helplessness of investors in the face of managers. This is the underpinning of the ALI's proposals on corporate governance.²

Although the ALI's drafters do not set out their premises, their proposals and arguments seem to rest on the Berle and Means diagnosis of helplessness. They believe that managers have seized control, that investors are powerless, and that other forms of control (such as competitive product markets, competition among managers, and competition for corporate control) have failed.³ Nonetheless, they do not propose the Berle and Means cure of public control. They recommend instead that control be transferred from managers to "independent" directors, who will be a majority of the board and will review compensation and all significant dealings between managers and the firms. They view independent directors as a cure for "market failure." They also recommend that some kinds of transactions be banned outright and that managers and investors alike be prohibited from adopting

2. The ALI has authorized the drafting of the *Principles of Corporate Governance: Analysis and Recommendations*, but the drafts to date are proposals of the Chief Reporter and his staff. Only a few have been discussed by the Institute, and none has been finally adopted. I refer to them as "the ALI's proposals" with the recognition that this shorthand is not accurate.

3. See *Principles of Corporate Governance: Analysis and Recommendations* (Tent. Draft No. 2) at 54, 74-76 (1983). The draft not only fails to set out a clear approach but also appears to draw on contradictory premises. See Romano, *Metapolitics and Corporate Law Reform*, 36 Stan. L. Rev. 923, 956-63 (1984); Weiss, *Economic Analysis, Corporate Law, and the ALI Corporate Governance Project*, 70 Cornell L. Rev. 1 (1984). Things are clearer in the recent work of Melvin Eisenberg, now the Chief Reporter of the project. See Eisenberg, *The Modernization of Corporate Law: An Essay for Bill Cary*, 37 U. MIAMI L. REV. 187 (1983), which is filled with unsupported assertions that managers and state law exploit investors and does not cite, let alone discuss, any contrary data and theory.

contracts at variance with the terms laid down in the ALI's model code.

The ALI's proposals remove control from self-interested managers, ignorant (and passive) investors, and bureaucrats dominated by interest groups. They place it in the hands of disinterested directors and disinterested judges. The drafters evidently hope that these two disinterested groups will achieve the benefits of knowledgeable management without the taint of self-interest.

There is a curious flavor to the Berle and Means vision. They (and the ALI's drafters) see the world as if everyone awakened one morning to find himself a manager or an investor. The veil of ignorance was suddenly parted. The manager stepped out and exalted: "Aha! No one can stop me!" The investor gasped: "Woe is me, I'm powerless. Only the ALI can save me now!"

This vision omits dynamic elements vital to an appreciation of corporate organization. Managers and investors do not wake up in this way. They assume their roles with knowledge of the consequences. Investors part with their money willingly, putting dollars in equities instead of debt, T-Bills, land, or gold because they believe the returns of equities are more attractive. Managers obtain their positions after much trouble and toil, competing against others who desire the same posts. There are no third-party effects; all interested people participate in the process, so the correct incentives are in play. Corporations are born small and grow. They must attract customers and investors by promising *and delivering* what those people value. Corporations that do not do so will not survive. When Berle and Means observe that firms are very large in relation to single investors, they observe the product of success in satisfying investors and customers.

My purpose in this paper is to identify some of the dynamic elements that the Berle-Means-ALI vision leaves out. I discuss some of the ways in which competition over the course of years and decades induces managers to act in the interests of investors, even if each investor is powerless.

A warning. None of the competitive devices is costless or perfect. Indeed, all are quite costly, and all together leave room for occasional fraud and managerial slack. We live in an imperfect world. There is bound to be some divergence between investors' interests and managers' actions. The ALI's proposals rest on the view that if markets have costs and imperfections, then we need legal rules to overcome them. This is a non-sequitur. The observation that there are costs requires us to ask further questions. How large is the divergence? Can it be reduced by new legal rules without incurring costs that exceed the benefits? These are empirical questions, and I offer some evidence that bears on them. The evidence is not conclusive, but it is powerfully

suggestive. It supports the conclusion that markets operating under current legal rules (such as prohibitions against fraud and general fiduciary duties) have been quite successful in aligning the interests of investors and managers.

Existing rules, enforced by private suits and the criminal law, are important in inducing managers to take care of investors' interests. Contractual promises of faithful service would be worth much less in the absence of these rules. But they are not the only safeguards, or even necessarily the most important ones. I discuss below three market mechanisms that also induce managers to act in the interest of investors. The first is the managers' desire to raise money, which they must do if they are to have anything to manage. To raise money, they must promise to control themselves and to act as honest agents of investors. The second mechanism is the market for the firm's stock and products. Managers must continue to run the firm well to avoid failing in these markets. If they fail, they soon will lose their jobs (or chunks of their compensation). Even managers with assurance of tenure must succeed in these markets to have funds they can appropriate. The third market is the one in "corporate control." Managerial teams monitor each other, and they wage proxy fights and tender offers if performance declines.

I. THE MARKET FOR CAPITAL: COMPETITION TO ATTRACT INVESTORS

A. Theory

I have sketched the Berle and Means theory above. Their approach starts with an assumption that managers act in their own interest rather than in that of investors, adds the fact that investors are too widely scattered to control managers, and concludes that managers' discretion is effectively unchecked (or at least "inadequately" checked). Having obtained control, managers will misuse their position. The investors need help.

A different theoretical tradition asks just how it is that managers came to control such resources.⁴ Berle and Means were not the first to notice that scattered investors can't control managers. The investors

4. The outstanding contribution is Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). But this tradition is at least as old as that of Berle and Means. See Coase, *The Nature of the Firm*, 4 *Economica* (n.s.) 386 (1937). Other important contributions include

knew so, too. Indeed, the costs of divergence of interest ("agency costs of management") are common knowledge.

If the investors knew that the managers would have excessive discretion, why did they give their money to these managers in the first place? If managers promise to return but a pittance, the investors will not put up very much money. The investors simply pay less for the paper the firms issue. There is therefore a limitation on managers' efforts to enrich themselves at investors' expense. Managers may do their best to take advantage of investors, but they find that the dynamics of the market drive them to act as if they had investors' interests at heart. It is almost as if there were an invisible hand.

The corporation and its securities are products to as great an extent as the sewing machines or other items the firm produces. Just as the founders of a firm have incentives to make the kinds of sewing machines people want to buy, they have incentives to create the kind of firm, governance structure, and securities people value. The founders of the firm will find it profitable to promise the governance structure that is most beneficial to investors, net of the costs of maintaining the structure. Managers who seek resources to control will have to promise more returns to investors. Those who promise the highest returns, and make the promises binding, hence believable, will obtain the largest investments.

The first question facing managers is what promises to make, and the second is how to induce investors to believe the promises. Empty promises are worthless. Answering the first question depends on finding ways to reduce the effects of divergent interests; answering the second depends on finding legal and automatic enforcement devices.

Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 *Am. Econ. Rev.* 777 (1972); Manne, *Some Theoretical Aspects of Share Voting*, 64 *COLUM. L. REV.* 1427 (1964); Manne, *Mergers and the Market for Corporate Control*, 73 *J. POL. ECON.* 110 (1965); and Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. LEGAL STUDIES* 251 (1977). See also M. Jensen & C. Smith, *Shareholder, Manager, and Creditor Interests: Applications of Agency Theory*, University of Rochester MERC Working Paper 84-03 (Jan. 1984), for a summary of the theory; Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 *V.A. L. REV.* 669, 673-79, 687-92 (1984) [hereinafter cited as Easterbrook & Fischel, *Mandatory Disclosure*] (discussing managers' incentives to create securities and provide disclosure that investors prefer). The theory I advance here is evolutionary. Jensen & Meckling give a static argument for which evolution is a less apt metaphor, but Jensen's more recent work is expressly an evolutionary argument.

The more automatic the enforcement, the more investors will believe the promises.

What promises will the managers make to induce investors to hand over more money? It should be plain that no one set of promises is suited for all firms at all times. No one thinks that the governance structure used for a small business will work well for Exxon. The "best" structure cannot be derived from theory; it must be developed by experience. We should be deeply skeptical of claims that any one structure or class of structures is best. But we can see the sorts of promises that are likely to emerge in the competition for investments.

Some promises may entail submitting to scrutiny in advance of action. The managers may set up prior monitoring. Outside directors may watch inside ones; inside directors may watch other managers; managers may hire detectives to watch the employees. At other times, though, prior monitoring may be too costly in relation to its benefits, and the most desirable methods of control will rest on deterrence, on letting people act as they wish but penalizing certain conduct. Fiduciary obligations and derivative litigation are forms of subsequent settling-up that are among these effective protections of the agency relation. Still other methods operate automatically. Managers enjoy hefty salaries and perquisites of office; the threat of losing these can induce managers to act in investors' interest.

Managers select the state of incorporation. States offer different menus of devices (from voting by shareholders to fiduciary rules to derivative litigation) for the protection of investors. The managers who pick the state of incorporation that is most desirable from the perspective of investors will attract the most money. The states that select the best combination of rules will attract the most corporate investment (and therefore increase tax collections). So states compete to offer, and managers compete to use, beneficial sets of legal rules. These include not only rules about governance structures but also fiduciary rules and prohibitions of fraud.

Managers select when to go public. Less experienced managers start with their own money or with venture capital, which comes with extensive strings. The venture capitalists control the operation of the firm with some care. Only after the managerial team and structure have matured will the firm issue public securities.

Managers make promises in the articles of incorporation and the securities they issue when they go public. The debt investors will receive exceptionally detailed promises in indentures. These promises will concern the riskiness of the firm's operations, the extent to which earnings may be paid out, and the domain of managerial discretion. These promises benefit equity investors as well as debt investors. The equity

investors usually receive votes rather than explicit promises.⁵ These voting rules make it possible for the investors to replace the managers. (Those who believe that managers have unchecked control should ask themselves why the organizers of a firm ever issue equity claims that enable the investors to replace the managers.) The managers also promise, explicitly or otherwise, to abide by the standards of “fair dealing” embedded in the fiduciary rules of state law. Sometimes they make additional promises.

To sum up: self-interested managers, just like other investors, are driven to find the devices most likely to reduce agency costs. If they do not, they pay in lower prices for corporate paper. Any one firm may deviate from the optimal measures. Over tens of years and thousands of firms, though, tendencies emerge. The firms and managers that make the choices investors prefer will prosper relative to others. Because the choices do not impose costs on strangers to the contracts, what is optimal for the firms and investors is optimal for society. We can learn a great deal simply by observing which devices are widely used and which are not.

It is important to distinguish between isolated transactions and governance structures. There are high costs of operating capital and managerial markets, just as there are high costs of other methods of dealing with the agency relation. It is inevitable that a substantial amount of undesirable slack or self-dealing will escape punishment by markets. The question is not whether this occurs, but whether the costs of this shirking can be reduced by mechanisms that are not themselves more costly. We accept some costly conduct because the costs of the remedy are even greater. We also use deterrence (say, the threat of punishment for fraud) rather than other forms of legal control when deterrence is the most economical method of handling a problem.

Markets that let particular episodes of wrongdoing slide by, or legal systems that use deterrence rather than structural change to handle the costs of management, are likely very effective in making judgments about optimal governance structures. Governance structures are open and notorious, unlike the conduct they seek to control. Costs of obtaining information about a firm’s governance are low. Firms and teams of managers can compete with each other over time to design governance structures and to build in penalties for malfeasance. There is no substantial impediment to the operation of the competitive process at the level of structure. Contractual promises and fiduciary rules arise as a result of these considerations.

5. For an analysis of why voting rules are as they are, see Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983).

B. Evidence

It is not easy to test the divergent theories presented above. Testing depends on finding differing predictions about observable things, and these are rarer than one might think. Suppose Berle and Means are right, and managers will *not* implement the governance structures that are most beneficial to investors but instead select rules that make shirking and appropriation of investors' funds easy. This implies that securities in firms sell for less than they would fetch if managers made enforceable promises to act in investors' interests. Yet how could we detect this?

We cannot measure this gap by comparing one firm against another, because each firm is a unique bundle of assets, prospects, and managers. We also cannot compare the price of, say, Apple Computer stock under optimal governance structures with its actual price. We cannot even compare the consequences to investors of putting money into the hands of exploiting managers versus the consequences of entrusting money to "better" managers (or managerial teams that have established better governance structures). Because no group of managers has power in the market for capital assets, the investors would do equally well entrusting money to either group. They would just pay less in the first instance for the stock of the firms that had inferior structures.

One type of inquiry that might help to differentiate the theories is whether firms adopt "investor protection" policies in the absence of legal compulsion to do so. There is substantial evidence along these lines.

Firms voluntarily arrange with debt investors to restrict managers' discretion. The promises in indentures—most of them wholly contractual—are extensive. Firms voluntarily issue equity securities with voting rights attached, even though these rights allow the investors to evict managers. Firms could confine voting securities to the managers themselves, issuing only nonvoting stock to outside investors, but they do not.⁶ They vote on many issues, such as the level of executive compensation, on which the decision of the board would be binding even without shareholders' approval. Firms place "disinterested" directors on their boards in large numbers, although no law requires this.

6. The New York Stock Exchange declines to list the securities of firms with nonvoting common stock. This is a wholly private arrangement. No rule requires it, and other exchanges (such as the American) do not have the same requirement.

These directors, and others invited onto the board by managers, frequently oust their former patrons and bring in new managers because they conclude that the existing ones are no longer best for the firm.

Long before federal law required annual audits by independent accountants, every firm listed on the New York Stock Exchange had such annual reviews. Indeed, auditing has existed for as long as firms have existed.⁷ Similarly, firms made extensive disclosures to investors well before state and federal law required such disclosures. To a substantial degree, federal law simply codified the accepted disclosure practice of the established investment banks and underwriters.⁸ Today, despite the many rules requiring disclosure of particular facts, two thirds of large corporations' disclosure expenditures are incurred to supply information in excess of that required by law.⁹

All of this evidence suggests that managers do not need legal commands to induce them to establish governance structures that serve investors' interests. Nonetheless, the evidence is rather impressionistic. How much independent auditing is the "right" amount in the investors' interest? Was the amount of disclosure before 1934 the "right" amount, or is it "right" now? (Maybe neither is optimal.) How can we know whether firms are acting to assist investors or to stave off further legal regulation?

Evidence from the stock market provides a cleaner test. Firms can increase the price of their stock by selecting articles of incorporation and other "constitutional" rules beneficial to investors. Although we cannot observe the effects of these provisions directly at the time

If managers wanted to exploit their control to the fullest, we would expect them to induce the NYSE to change the rule, or to list their firms on the American or NASDAQ systems. (It is no answer to say that firms "must list on the NYSE to get the prestige and advantages of the largest, most liquid exchange." If managers wanted to reclaim control of voting, they would list on the American, which then would be the largest exchange, with all the "advantages" firms now get on the NYSE.)

7. For a sampling of the evidence, see Benston, *Security for Investors*, in *INSTEAD OF REGULATION* 169 (R. Poole ed. 1981); Watts & Zimmerman, *Agency Problems, Auditing, and the Theory of the Firm: Some Evidence*, 26 *J. L. & Econ.* 613 (1983).

8. This is one reason, among many others, why the apparently promising approach of seeing whether investors have done "better" after the securities acts does not reveal whether managers act optimally in investors' interests without legal compulsion. See Easterbrook & Fischel, *Mandatory Disclosure*, *supra* note 4, at 707-14, for a summary of the evidence developed in such comparisons and an assessment of why the data are not illuminating.

9. S. PHILLIPS & J.R. ZECHE, *THE SEC AND THE PUBLIC INTEREST* 50 (1981) (Table 3.3).

firms first go public, we can observe the effects of changes. One important "constitutional" choice is the state of incorporation. State law provides many of the rules by which the firm operates day to day. Most of these are just "fallback" rules that govern when the articles are silent; a few are mandatory. State law also includes the fiduciary principle, a guarantee of honest and "fair" dealing when firms do not spell out in the articles exactly how certain transactions will be handled. Both the statutory and fiduciary rules vary slightly from state to state, so the place of incorporation will influence investors' welfare.

For several decades, Delaware's law has afforded managers the greatest discretion. The statutory law allows almost unlimited alteration of rules in the articles and bylaws, which managers control. And the Delaware fiduciary principle allows most forms of self-dealing transactions, so long as the terms approximate those that might be reached in arms' length bargaining. In Delaware managers may pursue "corporate opportunities" after obtaining the board's consent, and they may engage in mergers, going-private transactions, and other deals that squeeze out public shareholders at prices set largely by the managers. These and other features of Delaware law led scholars in the Berle and Means tradition to conclude that Delaware had won a "race for the bottom."¹⁰ By enhancing managers' discretion, they argued, Delaware had sacrificed investors' interests.

This is a wonderfully testable proposition. Delaware law increases managers' discretion. If the Berle and Means hypothesis is correct, firms that move their place of incorporation to Delaware do poorly for their investors. Lower expected earnings will lead to lower prices in the stock market.¹¹ If, on the other hand, markets constrain managers to act in investors' interest, then a move to Delaware would be neutral or even lead to an increase in the price of stock.

10. See Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974). The flexibility and managerial discretion to which Cary objected continue to characterize Delaware law. On the statutory side, see, e.g., Del. Code Ann. tit. 8, § 141 (board may delegate), § 144 (standards of self-dealing conduct), § 228 (majority may act without meeting), § 251 (limits on shareholders' role in mergers), § 262 (limits on appraisal remedy). On the judicial side, see, e.g., Aronson v. Lewis, 473 A.2d 805 (Del. Sup. 1984) (strong business judgment rule protects discretionary decisions unless director is on both sides of transaction); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. Sup. 1983) (approving freezeout mergers in principle, limiting judicial inquiry, and holding appraisal remedy exclusive in absence of fraud); Field v. Allyn, 457 A.2d 1089 (Del. Ch. 1983) (approving leveraged buyout; applying "equal dignity principle" to allow managers to choose the least-restricted way to conduct any transaction).

11. The price of stock depends on investors' evaluation of their future returns.

Peter Dodd and Richard Leftwich looked at what happened to the investors in the 140 firms listed on the New York Stock Exchange that had moved their place of incorporation to Delaware between 1927 and 1977. They found these firms were doing better than expected before the move (that is, their stocks were rising compared with portfolios of similar stocks), that the price of their stock rose still further in the month the move was announced, and that the price continued to rise after the move.¹² The total unexpected gain was about 2.9% in the eighty days surrounding the move, 11.65% over a longer period. The verdict of investors: an increase in managers' discretion was beneficial, not detrimental. This is a substantial challenge to the Berle and Means hypothesis, substantial support for the hypothesis that markets induce managers to act in investors' interest.

This does not mean that more discretion is always better. It means, rather, that the existence of choice, of ability to elect a high-discretion system, is beneficial. For many firms at many times, it is advantageous to hem in managers' discretion. One need only think of close corporations to see why and to see restrictions in practice. The existence of different ownership structures also implies the utility of different legal

Reduce the expected returns, holding other things constant, and the price of stock will fall. Increase the returns and it will rise. All of the stock market research reported below uses this principle. It holds constant other changes in the economy and particular industries by identifying the difference between how a firm's stock does on a day when there is "news" and how it would have been expected to do—given its past volatility and relation to the rest of the market—had there been no news specific to the firm. See Schwert, *Using Financial Data to Measure Effects of Regulation*, 24 J. L. & ECON. 121 (1981), and Brown & Warner, *Using Daily Stock Returns: The Case of Event Studies*, 14 J. Fin. Econ. 1 (1985), for an explanation of the method.

This approach does *not* depend on stock prices being efficient in the sense that they correctly reflect all information about each firm. It rests, rather, on the assumption that the degree of accuracy does not change radically over short periods. Thus if the price of stock rises 1% relative to expectations, and the new price is not "more accurate" than the old, it is appropriate to conclude that the increase reflects "good news" worth approximately 1% of the equity in the firm. Because prices of stock are substantially influenced, if not determined, by the professional investors who have prompt access to news and who control pools of capital that they can shift rapidly from one stock to another, it is unlikely that any bit of information about a firm (or category of firms) could cause a sudden change in the extent to which prices reflect real values. Thus the implications laid out in the following text are adequately supported by the methodology. See also R. BREALEY, *AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS* (2d ed. 1983), [hereinafter cited as R. BREALEY] for information on the methodology and its reliability.

12. Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" vs. Federal Regulation*, 53 J. Bus. 259 (1980).

structures, so that managers and investors can choose the legal structure best suited to their needs. One recent study showed that both "loose" and "strict" laws can be advantageous for different kinds of firms, and that firms migrate to the states whose legal structures are best adapted to the firms' ownership structure.¹³

It is possible to examine the effects of adding discretion-increasing rules to articles of incorporation. Financial economists are performing such studies in increasing numbers. So far the results are mixed, as we should expect in light of the fact that more discretion is not always better. Some studies find gains for investors. But studies of "shark repellent" amendments to charters—that is, provisions giving managers greater discretion to defeat tender offers—come to conflicting conclusions.¹⁴ It seems safe to say that studies will find examples of some managerial conduct harmful to shareholders. This is not surprising. As I said above, markets do not perfectly align the interests of managers and investors. Nonetheless, the findings to date have two aspects. They suggest (a) that the provisions in the articles at the time the firm issued stock were valued by the investors, and (b) that the

13. See Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, in 28 J. L. & ECON. 179 (1985) (showing that firms with scattered shareholders select and gain from incorporating in "liberal" states, while the more concentrated the investments the more likely a firm is to select and gain from incorporation in a "strict" state). For other confirming evidence on the benefits of competition among jurisdictions see Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. Legal Studies 129 (1985); R. Romano, *Some Pieces of the Incorporation Puzzle* (draft Nov. 1984).

14. DeAngelo & Rice, *Antitakeover Charter Amendments and Stockholder Wealth*, 11 J. FIN. ECON. 329 (1983), uses data on daily prices and concludes that announcement of such amendments harms stockholders, although the firms making such changes generally have stocks rising relative to market. This may be interpreted as evidence that such firms are perceived as targets (hence the rise in price) but that the amendments decrease somewhat the value of this chance to investors. Linn & McConnell, *An Empirical Investigation of the Impact of "Antitakeover" Amendments on Common Stock Prices*, 11 J. FIN. ECON. 361 (1983), uses monthly price data and concludes that the amendments are associated with price increases. The differences in the data make the two studies not contradictory, but they leave unanswered whether increased managerial discretion here helps or harms investors. A study by the SEC released in November 1984 shows that different anti-takeover amendments have different effects, some negative and some positive. One possible conclusion is that managerial discretion to defeat the market for corporate control is harmful to investors. See Part III below.

Bhagat, *The Effect of Pre-Emptive Right Amendments on Shareholder Wealth*, 12 J. FIN. ECON. 289 (1983), and Bhagat & Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 J.L. & ECON. 339 (1984), find that changes in certain rules (the elimination of preemptive rights and cumulative voting) are associated with declines in the price of stock. These rules are not obviously tied to "managers' discretion" in running the firm; indeed, it is not clear just how preemptive rights and cumulative voting affect managers' conduct.

provisions the managers later selected were less highly valued. The findings confirm that managers initially picked "good" rules and indicate that the later change was undesirable. Perhaps such findings indicate the utility of rules of law that make changes in the articles difficult and scrutinize them carefully. Opportunism by managers seeking to breach the optimal contract provisions written when a firm goes public may be a significant problem.¹⁵

It would be nice to have still further studies. Few if any firms include in their constitutional documents any inhibitions on insiders' trading in stock. It is sometimes said that this demonstrates that managers are willing and able to take advantage of investors. If the market were operating properly, the argument runs, managers would have limited their compensation to such publicly approved forms as salary, bonuses and stock options. Henry Manne and others have argued in response that firms do not prohibit such trading by contract because inside trading is beneficial to investors.¹⁶ Just to confuse things, I have argued that even if insider trading is harmful to investors, we should not expect to see contracts prohibiting it, because the contracts are too costly to write and enforce.¹⁷

These and other controversies about the effectiveness of the market in extracting optimal promises from managers raising capital could be illuminated by further empirical work. Financial economists are designing and executing some of these tests. It is therefore premature to say that the evidence proves or disproves any particular assessment of the effects of managers' discretion.

15. The hardest questions in corporate law concern arrangements that are adopted or changed after the firm is under way and the capital has been raised. Shareholders' approval of changes is likely to be unreliable as an indicator of their interests, because scattered shareholders in publicly-held firms do not have the time, information, or incentives to review all proposed changes. Thus doctrines of corporate law refusing to allow shareholders to ratify waste (except unanimously) are well-founded. Yet the rules for amending the rules are themselves part of the original articles, and it is (or should be) possible to draft limitations on amendment. These most commonly take the form of provisions designating some amendments as transactions from which investors may dissent and demand appraisal. Moreover, amendments to governance structures may spark proxy contests in which investors' attention is focused, and they also may call forth takeover bids. On this reasoning, provisions for governance set out in amendments to the articles should be fully enforced. This is not the place to resolve such difficult issues, if they can be resolved at all.

16. H. Manne, *Insider Trading and the Stock Market* (1966); Carlton & Fischel, *The Regulation of Insider Trading*, 35 *STAN. L. REV.* 857 (1983).

17. Easterbrook, *Insider Trading as an Agency Problem*, in *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* 81 (J. Pratt & R. Zeckhauser eds. 1985).

The evidence does, however, support this more limited claim: Markets induce managers seeking funds to promise investors governance structures that investors value, and the data do not reflect ability on the part of managers to inflict systematic harm on investors by selection of governance rules. An increase in managers' discretion does not automatically lead investors to revise their estimates of return downward. Even so modestly put, the data inflict heavy blows on the Berle-Means-ALI hypothesis.

II. PRODUCT AND STOCK MARKETS: COMPETITION TO GENERATE PROFITS

A. *Theory*

From the Berle and Means perspective, managers need pay investors just enough to keep the wolf from the door. The rest of the profits they may keep for themselves. They will do this both by receiving excessive salary and by appropriating information from the firm, whether by engaging in inside trading or by allocating corporate opportunities to themselves. They will consume excessive perquisites, which may take the form of needless fringe benefits (corporate jets for personal pleasure) or power over others (arbitrary hirings, firings and decisions regarding what to make and where to make it).

Berle and Means, like the ALI's drafters, portray competition, after the firm is in business as ineffectual to induce managers to act in investors' interests. Disinterested directors, the ALI reasons, will not allow managers to keep the proceeds for themselves. They will compel managers to forswear self-dealing and to keep their noses to the grindstones.

No one denies that managers can set up perquisites, act in arbitrary ways, or make inferior decisions. There are plenty of examples of these things.¹⁸ The question is not whether managers have discretion, but

18. Harold Demsetz has made a strong argument that managers who are also substantial investors are more likely to take their income in perquisites (fringe benefits and arbitrary authority) than are other managers. Demsetz reasons that the owner-manager can obtain both tax benefits and on-the-job consumption from this strategy. The owner-manager will consume on the job when this is more valuable to him than the consumption at home that could be purchased with equivalent after-tax income. A non owner-manager gets only the consumption value of perquisites, which may be less than the value of money converted to consumption at home. Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J. L. & ECON. 375 (1983) [hereinafter

how much they have, and whether this amount can be reduced by legal rules that are worth the cost. The answers depend on whether "automatic" devices are effective in reducing, although not eliminating, the divergence of interest between investors and managers once the firm is under way. The argument that there are effective "automatic" devices follows.

After they have raised capital, the managers depend on the firms' profits for their salary and perquisites. Even if the managers' inside position gives them great ability to take advantage of the investors, they still find it advantageous to run the firms so as generally to maximize profits. Then there is a larger kitty into which they can dip. This may show up in the value of stock holdings and bonuses; in the longer run it controls salary as well.

From this perspective the question is not how to overcome the effects of managers' self-interest but how to put that self-interest to good use. Self-dealing transactions are one method of *curtailing* agency costs. To see why, consider the essential contradiction of the agency relation: the principal wants to hire the agent's dedicated service, yet the agent's loyalty remains largely to his own interests. To induce the agent to pursue the principal's interests, the principal must promise the agent a reward for success; yet the reward is itself a reduction in the principal's return, a cost of the agency relation. The greater the reward for success, the more dedicated the agent to the task and the better the result in pursuit of the principal's goals; yet the greater the reward, the less desirable the whole arrangement for the principal. There is a delicate balance. Some gains must be apportioned to the agent, some to the principal. Like all balancing efforts, there is no one "right" answer. Which apportionment methods work best—or work least poorly—is determined by observing which lead to success in the market.

The appeal to the agent's self-interest is an indispensable ingredient in making the agency relation work. The trick in constructing a corporate governance structure is to *align* the interests of the agents with those of the investors, not to pretend that self-interest is a pestiferous thing to be conquered. In large firms managers hold stock (and are paid in stock options, phantom stock, and bonuses) so that managers' prosperity depends on the success of the equity investors.

cited as Demsetz]. Certainly many of the customary examples of high-handed management (Henry Ford is a prime example) come from firms in which the manager was owner as well. Nonetheless, it is not necessary to pursue this insight here.

Similarly, the trustee under a bond indenture often is a large bank that independently loans money to the firm. This makes the trustee's reward depend on the repayment of the firm's debt, and it also induces the trustee to gather information and superintend the managers.

The promise of advancement within the managerial structure also aligns interests. Those most interested in advancement are the second and third tier of managers. These people not only want to move up but also have the best information about how the higher-ups are doing. They are therefore one logical group of watchdogs in the investors' interest.¹⁹ The investors gain if they are present on the board of directors, serving in that role. On this logic, a reduction in the number of "inside" directors, to make room for independent directors who have both less information about the firm and less reason to insist that the top managers perform up to standard, would be a step backward.

Some number of disinterested directors could serve a watchdog role too, because these would be particularly effective in monitoring the kinds of conflicts of interests that firms deliberately create in order to improve the incentives of managers. Nothing in this line of argument suggests that there is something "wrong" with outside directors. But the number of such directors that will benefit the firm is an empirical question. Outsiders give the firm an improved ability to monitor conflicts; outsiders cost the firm some of the self-interest that drives directors to find and pursue profitable business ventures. They, too, face an agency cost: diligence versus leisure. Their very disinterestedness makes leisure and carelessness more attractive. The outsiders also know less about the business than the interested directors. If they work substantially full time at the firm to acquire information, they become "inside" directors; if they do not spend substantially full time at the firm, though, they will never know enough to fulfill their monitoring functions. You can't run General Motors on ten hours a month.

This analysis suggests that, although there are functions for independent directors (which is why firms voluntarily have them), the functions are quite limited. The less-knowledgeable, non-interested directors may serve as passive evaluators of the performance of managers, and they may be able to initiate changes in the managerial team if performance falls off or the interest-alignment devices malfunction. It is unlikely, though, that outside directors could make investors

19. See Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Fama & Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301 (1983).

better off by reviewing most transactions in advance; their distance from the firm and their lack of interest ensures that they will not know enough to make discriminating choices.

There are other forms of control that do not appeal to the self-interest of managers. Professional investors continuously monitor ongoing firms, because they (or the funds they represent) have large sums at stake. When their assessment of the managers' dedication and performance falls, the price of the stock falls too. The lower price makes it harder for the firm to raise new capital in competition against other firms with more dedicated managers, and this puts great pressure on managers to improve. The higher the price of capital, the higher the firm's cost in making and supplying goods. The higher its cost, the less it can sell in competition with other firms that adopt superior management-control devices. It also makes less per sale. Lower profits mean diminished ability to divert benefits (and increased chance of replacement).

Although this chain from lower stock prices to lower sales to new managers seems a bit long, nothing in the economic treatment suggests that the effects occur immediately. The consequences of inferior managerial structures may take years to come home to roost when the performance is only "a little" sub-par. Yet recall that we are examining how markets influence *governance structures*, not particular acts of managers given the governance structure. The ALI proposes new governance structures, not new managers. The governance structures of firms are the product of decades of evolution under competitive pressure. Market forces that operate "in the long run" are *exactly* the forces that determine governance structures.

Back to capital markets. Other participants there also act as surrogates for the investors. The stock exchanges flourish when trading volume is high. The willingness of people to trade depends in large measure on their belief that they will get a fair deal. Thus it is in the interest of stock exchanges to establish rules for the protection of investors, and managers who seek to attract money will submit to these rules to obtain the benefit of being listed with other firms similarly constrained. All stock exchanges have significant listing rules and had them before the advent of regulation in 1934. For example, firms listed on the NYSE must obtain the approval of shareholders before issuing new stock exceeding 18% of the value of outstanding stock, and all stock must have voting rights; listed firms also must make certain timely disclosures and have audit committees.

The investment banks and underwriters through which firms issue

stock seek to maintain their own reputations. Accordingly, they make careful inspections of managerial quality and the accuracy of representations before they sell the firm's stock to the public. To obtain the endorsement of these firms, managers must make believable pledges to act in the investors' interests.

Competition in product markets has a similar effect. When managers' performance falls off, the firm's profits also fall off. Other firms, with more capable managers, will make the sales and the profits. This has two consequences. One works through the price of stock and the monitoring of market professionals. A drop in the price of stock implies higher cost of capital and still greater difficulties in product-market competition. The other is that when profits drop, managers simply have less they can divert to themselves. Even the managers with the greatest discretion over the disposition of the firm's income must produce income before they can dispose of it.²⁰

There is, finally, competition for the position of manager. In order to obtain desirable positions, would-be managers will offer to work for the competitive wage. Those who offer the best deal to the firm ultimately end up in control, just as those who offer to sell other inputs (whether steel or office space) on the most attractive terms end up as suppliers. Even if the most senior managers are in a position of complete control, they have no reason to let junior managers skim off profits. The senior managers therefore place their juniors under effective controls in order to keep the most for themselves. When the juniors are promoted, the controls stay in place, and the investors receive the benefits of the process.

B. Evidence

So much for the theory. What of the evidence? Once more it is hard to design tests in which the Berle-Means-ALI and investors'-welfare approaches give significantly different predictions. One can show, for example, that stock market prices change quickly and reasonably accurately to reflect available information about firms.²¹ One possible inference is that the disciplinary mechanism discussed above (self-centered managers drive down prices, and this in turn

20. For a formal demonstration of how this induces managers to act in investors' interests, see Hart, *The Market Mechanism as an Incentive Scheme*, 14 BELL J. ECON. 366 (1983).

21. See R. BREALEY, *supra* note 11; J. Lorie & M. Hamilton, *THE STOCK MARKET: THEORIES AND EVIDENCE* (1973). Reasonably accurate is not perfectly accurate, but here (as in horseshoes) close is good enough. See Gilson & Kraakman, *The Mechanics of Market Efficiency*, 70 Va. L. Rev. 549 (1984).

penalizes the managers for various reasons) is effective. The adherent of the Berle-Means-ALI position could concede the stock price effect, though, without conceding the effect of prices on managers' conduct.²² Some other test—outside the stock market—is therefore necessary.

Stock Ownership. One quick and dirty approach is to see whether managers believe they have the power to exploit investors. If managers believe the Berle-Means-ALI hypothesis, they will not invest in the stock of the firms they manage. Why should they pick their own pockets?

It turns out, however, that managers own stock—great quantities of stock. And the larger the firm, the more stock the managers own. Harold Demsetz computed the stock holdings by managers of firms from 1973-82. He found that the managers of the ten largest Fortune 500 firms owned outright an average of \$151,621 of their firms' stock.²³ Managers of middle Fortune 500 firms owned an average of \$124,560 of their firms' stock. The managers of the bottom ten in the Fortune 500 owned only \$27,134 of their firms' stock on average. The "top" managers of all of these firms own substantially more, often millions of dollars worth. And data show that the value of firms rises when they adopt compensation plans increasing managers' ownership interest.²⁴

It is important to distinguish ownership by value from ownership by percentage. As firm size increases, managers own smaller percentages of all outstanding stock. This is what Berle and Means reported and what Edward Herman confirms is still true.²⁵ The divergence in percentage of ownership is the source of the cost of the agency rela-

22. Oliver Williamson reports that a decline in profits is associated with a sharp reduction in the consumption of perquisites, such as "excessive" staff, that managers may prefer to compensation and may be able to employ when market discipline is weak. *Managerial Discretion and Business Behavior*, 53 AM. ECON. REV. 1032 (1963). This suggests a direct effect of profits on managerial conduct. Other studies find a similar effect as either product market competition or potential competition for corporate control increases. *E.g.*, O'Hara, *Property Rights and the Financial Firm*, 24 J. L. & ECON. 317 (1981).

23. Demsetz, *supra* note 18, at 388. This is one of the most modest estimates I could find. Edward Herman and even Ralph Nader report larger figures. E. Herman, *Corporate Control, Corporate Power* 91-95 (1981) [hereinafter referred to as Herman] (holdings averaging \$920,000 in 1974-75); R. Nader, M. Green & J. Seligman, *Taming the Giant Corporation* 116 (1976) (chief executives of largest corporations own average of \$1,566,009 of firm's stock).

24. Brickley, Bhagat & Lease, *The Impact of Long-Range Managerial Compensation Plans on Shareholder Wealth*, 11 J. ACCT. & ECON. 115 (1985).

25. Herman, *supra* note 23, at 87-93.

tion. Yet for many purposes the absolute quantity of stock ownership may be as important as the percentage of the firm's stock managers hold. Suppose a manager with an annual income of \$200,000 and \$2 million of wealth holds half of his wealth in the stock of his employer. Then a 10% drop (from \$1 million to \$900,000) in the market value of his stock is equivalent to a 50% reduction in salary. The stock ownership quickly brings home the consequences of the firm's doing well or poorly. It aligns the manager's interests with those of the stockholders, inducing the manager not only to perform well himself but also to ensure that other managers do likewise. The manager feels the consequences of price changes more quickly than an ordinary stockholder, whose portfolio will be more diversified and who therefore cares more about the market as a whole than about the prospects of a single firm.

Sources of Compensation. Stock ownership is not the only device aligning managers' interests with those of equity investors. Managers also design stock option plans (the right to obtain stock in the future at today's price, creating a "bargain" if the price rises) and phantom stock plans (bonuses paid according to increases in the price of stock). These and other stock-based compensation plans do not show up as stock currently "owned" by the managers, but they have similar effects.

The hypothesis that market forces induce managers to act in investors' interests predicts that a substantial portion of managers' compensation will come through devices based on the price of stock. Managers will get paid only to the extent (other) investors do well. The Berle-Means-ALI hypothesis predicts, to the contrary, that managers' compensation will come in salary, bonuses, perquisites, and other forms that are at least potentially at the expense of investors.

The evidence supports the investors' welfare hypothesis. Wilbur Lewellen reported in 1971 the results of a survey of compensation patterns at 50 of the largest manufacturers, 15 of the largest retailers and 15 small manufacturers, between 1940 and 1963. He separated the managers' compensation into cash-based (salary, loans, pension contributions, and the value of perquisites) and stock-based (dividends, appreciation or depreciation of shares owned, and the value of options). He found that for the top managers of the largest firms, the after-tax value of the stock-based compensation was three to five times the after-tax value of the other compensation.²⁶

26. W. LEWELLEN, *THE OWNERSHIP INCOME OF MANAGEMENT* (1971). *See also* Lewellen & Huntsman, *Managerial Pay and Corporate Performance*, 60 *AM. ECON. REV.* 45 (1970).

Surveys covering more recent years confirm the dependence of total managerial compensation on the performance of the firm's stock. George Benston's survey of the earnings of managers of 29 large conglomerates in 1970-75 shows that stock-based compensation dominated other forms of remuneration. Benston added stock- and cash-based returns. In years when the firms' stock rose 30%, these executives made more than \$1 million apiece; in years when the stock fell by that amount, they lost more than \$1 million apiece.²⁷ Other surveys show similar dominance of stock performance in the total compensation package.

Relation Between Performance and Compensation. The Berle-Means-ALI hypothesis and the investors' welfare hypothesis make different predictions about the relation between managers' compensation and the performance of their firms. Berle and Means predict rewards for absolute size, because managers of larger firms have control over more resources (there is more to divert), yet investors' control is diluted.²⁸ They predict little or no reward for performance, because managers with control can pay themselves no matter what and need not attend to investors' interests. The investors' welfare hypothesis predicts rewards for both size and profit. The reward for size comes about because larger pools of assets call for the supervision of higher-quality managers, and firms must pay for the extra skills they need.²⁹ The reward for profit serves as the spur for managers to act in investors' interests.

The data strongly support the investors' welfare hypothesis. Managers' compensation depends on both size and profit. There are so many studies of this relation that I report only three of the most recent.³⁰

27. Benston, *The Self-Serving Management Hypothesis: Some Evidence*, 11 J. ACCT. & ECON. 67 (1985). The actual figures for years when stocks generally declined: \$1,328,000 average loss in 1972; \$715,000 average loss in 1971; \$710,000 average loss in 1974. For high-growth years: \$1,138,000 average gain in 1971; \$1,735,000 average gain in 1975. For all years and outcomes, the value of stock changes swamped salaries by a ratio of five to one.

28. See also W. BAUMOL, *BUSINESS BEHAVIOR, VALUE, AND GROWTH* (1967).

29. A manager does more for investors by taking a \$10 billion firm from 6.5% to 6.7% return on investment than by taking a \$1 billion firm from 10% to 11% return. Because compensation should be related to the manager's marginal influence on the absolute return, it is necessary to look with caution at studies that estimate average (rather than marginal) profits or examine rates of return on investment.

30. See Jensen & Zimmerman, *Management Compensation and the Managerial Labor Market*, 11 J. ACCT. & ECON. 3 (1985), for an overview. Existing surveys in the legal literature overlook most of these studies, and so they understate the power of market

Barry Harris looked at the compensation of managers of 19 firms in the food industry (all in the 250 largest of the Fortune 500) from 1952-72. He found that a 1% increase in sales was associated with a 0.45% increase in executive compensation, and that a 1% increase in accounting profits was associated with a 0.23% increase in executive compensation.³¹ Kevin Murphy looked at the compensation of 366 executives from 57 of the largest manufacturing firms. He found that a 1% increase in revenues was associated with a 0.18% increase in total earnings (salary, bonus, and the value of new stock options), and that a 1% increase in the rate of return on assets was associated with a 0.15% increase in earnings.³² In both studies, reductions in sales, profits, and return on assets brought corresponding reductions in compensation.

The most interesting of the recent studies has been performed by Rick Antle and Abbie Smith. They looked at the three highest-paid executives in 39 large firms between 1947 and 1977. They inquired whether compensation (which they defined as the after-tax value of salary, bonuses, stock options, pension contributions, stock holdings, and some other ingredients) depended on the performance of the firm relative to other firms in the same industry. Many managers can obtain "average" performance, they reasoned; if every firm in an industry is prospering (or failing), there is nothing special for which its managers should be rewarded (or penalized). If, on the other hand, some firms stand out in profit (or loss), the managers should reap the rewards of their success (or failure). They found that about 65% of the variance in total executive compensation can be explained by differences in the firms' return on assets (that is, that compensation strongly depends on performance), and that most of this variance also depends on performance relative to the rest of the industry.³³ This strongly supports the investors' welfare hypothesis.

forces. *E.g.*, Vagts, *Challenges to Executive Compensation: For the Markets or for the Courts?* 8 J. CORP. L. 231, 247-52 (1983).

31. B. HARRIS, ORGANIZATION: THE EFFECT ON LARGE CORPORATIONS 25-39 (1983).

Note that for purposes of this and other studies, a "1% increase" is relative to the previous sales or profits. So an increase in profits from \$100,000 to \$101,000 is a 1% increase, and a change from a return of 10% on invested capital to a return of 10.1% also is a 1% increase.

32. K. MURPHY, ABILITY, PERFORMANCE, AND COMPENSATION: AN EMPIRICAL ANALYSIS OF EXECUTIVE WAGE PROFILES (Nov. 1983 draft). *See also* Murphy, *Corporate Performance and Managerial Remuneration*, 11 J. ACCT. & ECON. 11 (1985).

33. R. ANTLE & A. SMITH, AN EMPIRICAL INVESTIGATION INTO THE RELATIVE PERFORMANCE EVALUATION OF CORPORATE EXECUTIVES (Nov. 1983 draft).

Many of these studies show little relation between managers' salary and their firms' performance. Some people find this conclusion and infer that the market for managerial services does not work well. It is always necessary to adjust, as the studies I have mentioned do, for other aspects of managers' compensation. A rule restricting the fluctuation of salaries has many attractions to a firm. It provides managers with some income through times thick and thin, while changes in the value of managers' portfolio of holdings provide the incentive for better performance.

Relation Between Performance and Structure of Ownership. The Berle-Means-ALI hypothesis has implications for the effect of the structure of ownership on profits, managerial compensation, and the like. If inability of investors to control managers is deleterious, we would expect that as firms grow and holdings become more widely scattered, the performance of managers would decline, and with it the firm's profits. On this view managers' compensation would rise as the degree of investors' control declined. To the extent these implications depend on effects through the level of profits, they have been tested above and found wanting because compensation depends strongly on profit. It is possible to test them more directly, too.

One way to do this is to construct the relation between size of firm and managerial compensation and to determine whether the concentration of ownership affects the relation. We expect managers' compensation to rise with the size of firms, for reasons already explained. The question, then, is whether the managers of firms without effective investor oversight do better than might be expected from knowing the size of assets alone. George Stigler and Claire Friedland, using data available to (but unused by) Berle and Means, found that they do not.³⁴ They found that in a regression of salaries on the logarithm of assets, control type (management-controlled, shareholder-controlled, etc.) had no effect. Herman reports a similar conclusion.³⁵

Stigler and Friedland also inquired whether the profitability of firms depended on the concentration of control. The utility of "profit" studies is open to serious question because of the great difficulties in interpreting accounting numbers. Nonetheless, to the extent there are useful profit data, the prediction of the Berle and Means approach

34. Stigler & Friedland, *The Literature of Economics: The Case of Berle and Means*, 26 J. L. & Econ. 237 (1983).

35. Herman, *supra* note 23, at 112.

is unambiguous: the less control investors have, the more the managers will shirk, divert opportunities, consume perquisites, etc., and thus the lower the profit per unit of investment. Stigler and Friedland examined four sets of data for different industries and different years. In only one of these was there a significant effect of the sort predicted by Berle and Means.³⁶ And when this group of firms was re-evaluated using a slightly different format (using as an independent variable the percentage of shares controlled by the 20 largest investors, rather than a dichotomous owner vs. manager control variable) the effect vanished.

A different source of data suggests that control by managers is not fatal to profits. An extensive literature in antitrust reports findings that larger firms, and those in more highly concentrated industries, consistently obtain profits exceeding those of smaller firms.³⁷ It also turns out that within the concentrated industries, the largest firms consistently earn the largest rates of profit.³⁸ Once more, one may doubt whether these "profitability" studies tell us much of interest. To the extent they do, however, they are at odds with the Berle-Means-ALI approach. Larger firms generally have more widely-scattered holdings. Under the Berle and Means story, they therefore should earn lower profits. In fact, they earn higher profits.

Whether we attribute these profits to innovation and efficient conduct of the business, as some would do, or to oligopoly and monopoly, as other argue, is irrelevant. Both efficiency and monopoly may be the results of managers driven to act in investors' interests. (Those

36. The other three had negative coefficients on the control variable, indicating that management control was associated with smaller profits, but in each the size of this effect was too small to be statistically significant. (That is, it was so small that a statistician would not be confident that it was different from zero). See also Stano, *Executive Ownership Interests and Corporate Performance*, 42 S. ECON. J. 272 (1975) (reporting a negative, but not statistically significant, relation between degree of control by managers and corporate profitability; also reporting a strongly positive and significant relation between absolute amount of stock held by managers and firm's profitability). For a summary of other work, much of it reporting similar negative but not significant results, see DeAlessi, *Private Property and Dispersion of Ownership in Large Corporations*, 28 J. FIN. 839 (1973).

37. Weiss, *The Structure-Conduct-Performance Paradigm and Antitrust*, 127 U. PA. L. REV. 1104 (1979), summarizes many of these studies. See also INDUSTRIAL CONCENTRATION: THE NEW LEARNING (H. Goldschmid, H.M. Mann & J.F. Weston, eds., 1974).

38. Peltzman, *The Gains and Losses from Industrial Concentration*, 20 J.L. & ECON. 229 (1977); Demsetz, *Industry Structure, Market Rivalry, and Public Policy*, 16 J. L. & ECON. 1 (1973). See also Smirlock, Gilligan & Marshall, *Tobin's q and the Structure-Performance Relationship*, 74 AM. ECON. REV. 1051 (1984) (finding that relatively large firms enjoy higher ratio of stock price to asset value, suggesting higher profits).

who assert that managers disserve investors' interests also frequently argue that managers create monopolies, evade pollution and labor laws, bribe their customers, and otherwise expose themselves to criminal and civil liability, as well as loss of employment and social status, in pursuit of profits. Managers willing to violate the law must perceive themselves under substantial pressure to produce profits.)

III. THE MARKET FOR CORPORATE CONTROL: COMPETITION FOR POSITION

A. *Theory*

Berle and Means paint the firm as a static institution. "The managers" have "control" and retain it. The powerless investors must accept the crumbs the managers hand out. One of the dynamic elements Berle and Means omit is competition among teams of managers to have control. It is not written that today's managerial team will be in charge tomorrow; to the contrary, several devices create the possibility of revolutionary change.

However much (or little) power investors have in the Berle-Means-ALI world, managers have a great deal more. Each team of managers may use this position to compete for the control of other corporate assets. Indeed, it is useful to think of the process of management as an ongoing competitive struggle among teams of managers to exercise control. The profits to be made in changes of control induce managerial teams to monitor each other, and this monitoring by management may be much more effective than monitoring by passive investors. Those who are best at running firms will enlarge the span of their control; those who falter will be replaced. If the faltering team will not yield by resignation or merger, the potential replacement will use force, such as the hostile tender offer or proxy contest.

The corporate control contest is the direct answer to the agency cost problems inherent in the separation of ownership and control. When the costs of widely scattered ownership become too large—perhaps when managers fail to act in investors' interest—then the investment interests may be gathered up. The control fight reconcentrates ownership. It makes use of safeguards built into the shares when they were issued; the shares are freely tradable and carry votes that allow their owners to take control. The existing managers recognize that they will be subjected to a control contest if they do not act in investors' interest; this realization prompts them to behave appropriately whether or not a contest materializes.

B. Evidence

Berle and Means thought that managers were entrenched. They therefore portrayed control contests as of little use. The managers could stave off challenges. Worse, a control contest would just swap one set of managers for another, and on average the new managers would be no better for the investors than the old. If managers are impervious to the influence of the market for corporate control, we should see few contests of any sort and little or no improvement in shareholders' welfare when contests occur. If the investors' welfare hypothesis is correct, we should see distinct wealth increases associated with contests, and laws that decrease the efficacy of control contests should produce decreases in investors' wealth. The data support the investors' welfare hypothesis.³⁹

1. Proxy Contests

Proxy contests for corporate control are associated with substantial gains to investors, on the order of 5-10% of the total value of the equity interest.⁴⁰ Stock appreciates when the contest is announced and during the duration of the contest. The gains exist whether the insurgents win or lose. This may show that the contest keeps the incumbents on their toes, or it may be associated with the assembly of substantial blocs of stock during the contest. (See the discussion below on bloc assembly.) The data clearly refute any notion that proxy contests are unimportant or that they give control to "raiders" or "looters" who enrich themselves at the expense of investors.

2. Bloc Assembly

When one person assembles a substantial minority bloc in a firm, he may be able to exercise effective control because other interests are too widely spread to unite against him. It is often said that the owner of 25% of the stock of a large firm has "control." The owner of a smaller bloc may be on his way to control (perhaps against the wishes of existing managers). Berle and Means would predict that the assembly of such control blocs would give managers extra power by making insurrection by the investors that much more difficult. The

39. Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983), collects and evaluates most of the available evidence. The existence of this fine survey article makes it unnecessary for me to clutter this paper with supporting footnotes.

40. Dodd & Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 J. FIN. ECON. 401 (1983).

owners of blocs may divert profits to themselves, gaining more in their roles as insiders than they lose in their roles as investors. The existence of control blocs therefore should be associated with decreases in price. Under the investors' welfare hypothesis, the opposite should occur. The interests of the owner of the bloc are aligned with the interests of other investors; each wants shares to appreciate in price. The bloc's owner therefore acts to increase the firm's profits. The existence of the bloc reduces the agency costs of management.⁴¹

Again the data support the investors' welfare hypothesis. Bloc assembly is associated with increases in the price of stock outside the bloc. The larger the bloc, the greater the increase. When firms repurchase existing blocs (thus reducing the concentration of ownership), the price of stock outside the bloc falls by more than the value of the premium paid to the bloc's owner.⁴² Bloc assembly, and its effects on control, therefore appears to be useful in controlling the agency costs of management.

3. Tender Offers and Mergers

Both mergers and successful tender offers leave one team of managers in control of assets formerly managed by two teams. The resulting firm is larger and, by the Berle and Means approach, less subject to effective governance by investors. They would expect such transactions to result in a diminution of wealth. Under the investors' welfare hypothesis, in contrast, mergers and tender offers are the visible consequences of competition among managers for control, and the victors should be the managers who can make best use of the assets. Control changes should be accompanied by increases in the value of the assets.

One way to investigate the effect of control changes is to ask whether firms do better in states that facilitate such changes. In some industries there are significant differences from state to state in the

41. A more complete explanation of the dynamics of control contests of all sorts may be found in Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982), which also addresses questions concerning the effects of investors' portfolio diversification.

42. See Dann & DeAngelo, *Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control*, 11 J. FIN. ECON. 275 (1983); Bradley & Wakeman, *The Wealth Effects of Targeted Share Repurchases*, 11 J. FIN. ECON. 301 (1983); Scholes, *The Market for Securities: Substitution versus Price Pressure and the Effects of Information on Share Prices*, 45 J. BUS. 179 (1972); Office of the Chief Economist, Securities and Exchange Commission, *The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices* (Sept. 11, 1984).

amenability of a firm to takeover. Christopher James examined banking, an industry for which the variation is quite pronounced. He found that banks that are not subject to acquisition display substantially more managerial slack than banks that could be taken over.⁴³ This supports the thesis that the market for corporate control protects investors.

Other evidence, which Richard Ruback discusses in this volume, establishes that transfers of control by merger and tender offer are associated with very large increases in the value of the investments, increases on the order of 30%-50%. The appreciation of the acquired firm's stock is spectacular, but the combined value of the acquiring and acquired firm also increases substantially, by an average exceeding 10%. Even the stock *not* acquired in a tender offer appreciates in value, so that one cannot explain the premium as a payoff to some investors in exchange for access to a pool of assets that can be raided or exploited. The investors view the new managers as unambiguously preferable to the old. When a merger proposal or tender offer is withdrawn, on the other hand, the price of stock falls. If no acquisition is completed within two years, all appreciation in value disappears.

The existence of the premium shows that the combination is beneficial to investors. The size of the premium is nonetheless troubling. There are few acquisitions today at premiums in the 1-20% range. This means that when combinations could produce benefits of 20% or less to investors, they are unlikely to occur. The takeover device is not as beneficial to investors as it could be.

One shortcoming is that such control transactions are very costly. The expenses of investment banks, lawyers, and printers, the risks of litigation, and other costs discourage control transactions in search of small gains. Another difficulty is that the Williams Act substantially raised the bidder's costs and facilitated defensive tactics by targets, which raise the costs still farther.⁴⁴ After the Williams Act, state takeover laws, and the advent of defensive tactics, there have been fewer acquisitions than there otherwise would have been, and the value of acquisition programs has substantially declined.⁴⁵ Managers seek to

43. James, *An Analysis of State Acquisition Laws on Managerial Efficiency: The Case of Bank Holding Company Acquisitions*, 27 J. L. & ECON. 211 (1984).

44. See Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982); Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978).

45. See Jarrell & Bradley, *The Economic Effects of Federal and State Regulation of Cash Tender Offers*, 23 J. L. & ECON. 371, 398-403 (1980) Schipper & Thompson, *Evidence on the Capitalized Value of Merger Activity for Acquiring Firms*, 11 J. FIN. ECON. 85 (1983).

defend against the acquisitions. Those who defend successfully harm investors.⁴⁶ And as it turns out, the managers most likely to defend are those who own the least stock in the firm—a collateral confirmation of the findings of the influence of interest-alignment devices.⁴⁷

Corporate acquisitions therefore must be seen as a safety valve, as a response to substantial shortfalls in performance rather than as an ordinary constraint on managers' conduct. Nonetheless, the existence of this backstop influences the incentives of managers, who desire to reduce the risk of their replacement. In conjunction with the many devices discussed in the preceding sections, the market in acquisitions offers still another way of inducing managers to act in investors' interests.

4. Divestitures and Spinoffs

If the reorganization of management can lead to higher values by combining assets, it also should be able to lead to higher values by breaking up concentrations of assets. Spinoffs may reallocate assets to managerial teams that can make better use of them. The Berle-Means-ALI hypothesis, in contrast, portrays spinoffs as methods by which managers can use inside information to divert opportunities to themselves. This hypothesis predicts lower prices for the public's stock. Once more the evidence supports the position that managers act in investors' interests. When firms spin off assets to investors (creating two firms from one) or sell blocs of assets to third parties, public investors obtain gains of 7% to 10% on average.⁴⁸ These gains arise, though, only when the spinoffs and sales are voluntary; transactions needed to comply with regulatory orders produce no gains. The market apparently can discriminate beneficial changes of control from others.

46. See Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?*, 28 J. L. & Econ. 151 (1985) (data showing that strategies designed to defeat offers reduce wealth of investors); Easterbrook & Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277 (1984) (data showing that firms defeating offers cause substantial losses to investors; summary of other studies to same effect).

47. Walking & Long, *Agency Theory, Managerial Welfare, and Takeover Bid Resistance*, 15 RAND J. ECON. 54 (1984). See also Lewellen, Loderer & Rosenfeld, *Merger Decisions and Executive Stock Ownership*, 11 J. ACCT. & ECON. 209 (1985).

48. Schipper & Smith, *Effects of Recontracting on Shareholder Wealth: The Case of Voluntary Spin-offs*, 12 J. FIN. ECON. 437 (1983); Hite & Owers, *Security Price Reactions Around Corporate Spin-off Announcements*, 12 J. FIN. ECON. 409 (1983); Jain, *The Effect of Voluntary Sell-off Announcements on Shareholder Wealth*, 42 J. FIN. 209 (1985); A. Klein, *Voluntary Corporate Divestitures: Motives and Consequences* (unpublished Ph.D. dissertation, University of Chicago, 1983).

5. Leveraged Buyouts

The existing managers of a firm are among the contestants in any struggle for control. Just as there may be beneficial incentives in the threat (or actuality) of an outside takeover, so there may be gains from "inside takeovers"—going private transactions or leveraged buyouts.

Berle and Means would portray these transactions as methods of exploiting investors. The managers extinguish the investors' interests at a price that may not reflect the firm's full value. Because of their privileged position, the managers may hide important information or manipulate the price of the transaction to the investors' disadvantage. The investors' welfare hypothesis is that these transactions may reduce the agency costs of management by turning the managers into owners as well. The new manager-owners receive a greater share of gains at the margin and therefore become more dedicated and effective agents.⁴⁹ These transactions also may be marked by restructuring of management (one faction prevails over another). The existing managers (or faction or managers) cannot take the firm private unless they pay more than the pre-existing value of the stock. They also face competition from other, outside groups and must offer more in order to obtain control.

Here, too, the evidence refutes the Berle and Means approach. Leveraged buyouts are associated with average premiums of about 30% relative to the prior market price.⁵⁰ The investors thus receive substantial gains, as large on average as those in mergers or tender offers. The market for these arms' length transactions appears to constrain managers from exploiting their position and ensures that much of the gain is distributed to the original investors.

Perhaps more interesting, the data refute any claim that the managers are exploiting privileged access to information. If informational inequalities are responsible for the premium price, we would expect some of the premium to remain even after a going-private offer

49. These transactions are usually so highly leveraged that the managers will receive little or no return in the early years; the firm's profits must be used to retire the debt. If the firm is less profitable than expected, the debtholders will become the new controllers. If the managers make enough to pay off the debt, though, they may become fabulously wealthy (in ten years or so) as the full owners of a profitable firm. This large-stakes wager may be just the thing needed to create the incentives for the managers to maximize the firm's value.

50. DeAngelo, DeAngelo & Rice, *Going Private: Minority Freezes and Stockholder Wealth* 27 J. L. & Econ. 367 (1984).

has been withdrawn. The offer would cause some of the information to leak to the market, and it also might set the stage for a competing bid by outsiders. Yet this does not occur. When a going-private offer is withdrawn, the entire premium vanishes. The leveraged buyout must itself be the source of the benefits to investors.

IV. CONCLUSION

Something caused corporations to grow, some much faster than others. Something caused investors willingly to part with their money. Something led to the terms we see in corporate charters. These "somethings" must generally be good for investors and consumers. The firms under scrutiny are the survivors after all. Those that offered terms less useful for investors and consumers are gone.

Why have the current corporate governance structures survived? The hypothesis that managers design structures in investors' interest has many testable implications. So does the Berle-Means-ALI hypothesis about the relation between managers and investors. To the extent the evidence permits the rendition of a verdict, it is that the Berle-Means-ALI hypothesis may confidently be rejected. Its implications are not true.

It is easier to reject a hypothesis than to confirm one. The available evidence generally supports the investors' welfare hypothesis, but it does not do so on every occasion. A few studies have found categories of activities by managers that appear to harm investors. We therefore must be careful in assessing proposals for legal rules. Some rules may be "market perfecting" in the same sense as antitrust. They may make it easier to detect or penalize shortcomings of managers.

In constructing such rules, though, we must start with the best available data. These data suggest, although they cannot prove, that incentives present in existing markets generally induce managers to act in investors' interests. No proposal for change legitimately may be based on the Berle and Means hypothesis that managers consistently act at the expense of investors. Proposals for new rules should perfect the market by reducing its costs. One example would be rules that reduce the costs of waging contests for corporate control. Methods of writing legal rules that mimic the contracts that investors and managers would strike—if they could write and enforce agreements with no transactions costs—also hold some prospect of benefit. Most of the state law rules and fiduciary doctrines now in force are of this sort: they supply contractual terms subject to variance by such actual bargains as investors and managers find worthwhile.

The data supply no support for market-defeating rules. That is, none of the studies recounted above offers the slightest justification for legal rules that reverse actual contractual decisions or frustrate the making of new ones. The process by which corporate governance has evolved has been a mixture of innovation by states and innovation by firms. Some corporations have found new and better ways to establish governance—whether these ways concern voting or methods of internal organization, such as hierarchical versus multidivisional organization. The firms that have adopted the best structures (sometimes contracting around state law) have prospered. Then states write laws that use existing governance structures as models, as starting points that prevail unless negated by contract. The states' adoption of the new structures reduces the costs to other firms of adopting and implementing them. States that make the choices most beneficial to investors will attract incorporations.

This evolutionary process goes on continuously. There is no reason to "freeze" it with a uniform set of rules that cannot be altered by contract. Even if the ALI could pick "the best" rules for today's average corporations, it is unlikely that these rules would be best for *all* firms or that they would remain "best" for long for the average firm. Investors gain when managers are free to invent new devices and to use them in their pursuit of capital. Those who want to still the power of competition must make a case far more powerful than they have to date.

It is sometimes said that the disagreement between those who want to impose new restraints on corporate governance and those who oppose such restraints is a matter of "faith" or "ideology." All too often, the question is posed as whether one has "faith in the market." Putting the question this way implies that the data are weak or their interpretation problematic. That is just not so.

Benefits to investors are not a matter of faith. Protection of investors by markets is not a matter of belief. Competition among managers is not a political creed. No one should have "faith" in the market. We should resort, rather, to evidence about the market. And that evidence suggests the power of competition and existing arrangements in protecting investors.