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New Theory in Corporate Governance Undermines Theories Relied on by Proponents of
Short-Termism and Shareholder Activism

Since the mid-1970's the agency-cost theory, popularized by Michael Jensen, has been used and gilded by academics to justify and promote shareholder-centric corporate governance. The agency cost theory, along with Eugene Fama's efficient market theory and Milton Friedman's 1970 dictum that the sole purpose of the business corporation is to maximize profits for its shareholders, have been used to promote legislation, regulation and so-called "best practices" designed to limit the power of management and boards of directors to defend strategies designed to create sustainable long-term growth. So too these theories, combined with statistical studies purporting to show that attacks by activist hedge funds promote improved long-term performance and long-term shareholder value, have been used by Lucian Bebchuk to not only promote activism, but all forms of shareholder-centric governance. Indeed Bebchuk is such a fervent proponent of shareholder rights to govern corporations that he has argued that all material corporate actions should be subject to shareholder referendums, that the poison pill is unconstitutional and that the staggered board is so inimical to shareholder rights that it justified his creating a Harvard Law School group to promote proxy resolutions designed to force its abandonment.

A brilliant new study, *Principal Costs: A New Theory for Corporate Law and Governance*, by Professors Zohar Goshen and Richard Squire shows that the core assumptions behind the statistical and empirical studies that have been used by academics to justify short-termism and shareholder activism are seriously deficient. The study describes principal costs, the costs that arise when investors, due to incompetence or conflicts of interest, exercise control in a manner that reduces company value (such as preventing a very profitable capital investment in favor of funding a special dividend), as a corollary to agent costs, the costs that arise when managers do the same (such as making an acquisition in order to increase the size of the company for the purpose of justifying higher executive compensation). Principal costs have been largely overlooked by academics, whose focus has been solely on agent costs. The study posits that there is an unavoidable tradeoff between principal costs and agent costs and concludes that the division of control that minimizes the sum of principal costs and agent costs is firm-specific, driven by factors such as industry, business strategy and personal characteristics of the investors and managers. The principal-cost theory refutes the Friedman/Jensen/Fama/Bebchuk belief that, across all firms, governance structures that empower shareholders, such as majority voting and proxy access, increase firm value, while governance structures that grant management autonomy, such as dual class stock and staggered boards, decrease firm value. This belief ignores the impact of such governance choices on principal costs.

Principal-cost theory, in contrast, explains that the variety among existing governance structures reflects the real-world, firm-specific nature of the principal-cost/agent-cost tradeoff, and accurately predicts that, across the governance spectrum, firms will be found to generate consistent levels of financial returns once firm-specific characteristics are properly taken into account. The Goshen-Squire principal-cost theory promises to be a seminal development in the current efforts to curb short-termism and shareholder activism and restore balanced management-centric governance. It is strong support for *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*, which was approved at the August 2016 meeting of the International Business Council of the World Economic Forum.

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