

# THE LAW AND THE BALANCE BETWEEN DISCRETION AND ACCOUNTABILITY IN CORPORATE GOVERNANCE

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## Keynote speech / Summary

A big corporate governance debate today is on the so-called short-termism of publicly held companies. In response to actual and anticipated pressure from activist hedge funds companies are, some say, becoming too short-term, for instance by way of shunning research and development expenditures. This behaviour harms shareholders and the greater society insofar as the production of short-term results undermines the maximization of long-term value. This debate is not new. A similar argument was deployed against hostile takeovers in the 1980s. Both then and today, the debate has been highly polarized between those welcoming keeping management on their toes and those concerned about the value-destroying consequences of short-termism. Both camps, indeed, seem to have a point.

The short-termism debate is a reflection of a more fundamental issue. This is to say, what is the right balance between managerial discretion and accountability in corporate governance? Managerial accountability enables the shareholders to monitor the managers in a principal-agent relationship. Managerial discretion enables the agent to exercise judgment as to what is in the principal's best interest, including the pursuit of long-term goals. The balance between discretion and accountability in corporate governance largely depends on the

distribution of powers in corporate law. This means distribution of powers between the management and the shareholders, in dispersed ownership structures, and between controlling shareholders and minority shareholders, in concentrated ownership structures. The balance between discretion and accountability is set initially by the company's jurisdiction and articles of incorporation. Once it is set, this balance is difficult to alter over time even though the company would benefit from a different balance.

In my recent article with Claire Hill,<sup>1</sup> we have contended that there is no such thing as a general short-termism problem in corporate governance. Because the right time horizon for a company is not known, managers complaining about activist hedge funds' short-termism might well suffer from long-termism, i.e. postpone the realization of underperformance for want of better times that will never come. However, hedge fund activism creates a short-term bias. Activists follow a playbook geared towards short-term results, which cannot be efficient for every company in every point in time. While some companies benefit from short-term feedback, some do not. The impact of activist hedge funds on companies for which short-termism is detrimental depends on how much leeway the management has, which in turn depends on the balance between managerial discretion and accountability. Companies should be able to choose this balance and to alter it over time. We argue that dual-class shares are the right legal tool to enable this choice.

We introduce a novel conceptual framework. We define justification cost as the cost of suboptimal managerial choice depending on accountability. Accountability prompts managers to act with a view to justification. Justification reduces the traditional agency cost of monitoring the agent, because conducts such as tunnelling or empire building are harder to justify. In addition, justification protects an agent's downside in case of underperformance, which can then be attributed to bad luck in the eyes of the principal. Therefore, justification may also increase agency cost to the extent that managers choose the actions that can be justified instead of those that are in the best interest of shareholders. We call this form of agency cost justification cost to distinguish it from traditional agency cost. On this perspective, accountability becomes excessive when it increases justification cost to a large extent than it decreases traditional agency cost.

Justification cost becomes higher, and thus is likelier to exceed traditional agency cost, in contexts of high uncertainty. In the presence of Knightian uncertainty, agents find justification comparatively more difficult because actions cannot be based on broadly accepted probability distributions or other conventional wisdom. Therefore, accountability

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<sup>1</sup> Hill, C. A., & Paces, A. M. (2018). The neglected role of justification under uncertainty in corporate governance and finance. *Annals of Corporate Governance*, 3(4), 276-407. <https://doi.org/10.1561/109.00000016>

prompts agents to avoid uncertainty. Managers who are accountable would rather seek short-term results (outcome accountability) or failing those, defensible procedures for decision-making (process accountability). Although playing it safe is beneficial for purposes of accountability, it is costly to the extent that avoiding uncertainty implies refraining from being entrepreneurial in corporate governance. Lack of entrepreneurship may be harmful for shareholders and for the society at large.

The main implication of this framework is that there is no one-size-fits-all balance between discretion and accountability in corporate governance. The efficient balance varies with the particular company and over time. Although every managerial decision entails uncertainty to some extent, uncertainty is not always compelling. Sometimes justification-minded actions are the best agents can do to pursue the principal's interest. Think for example of companies having excess cash that engage in acquisitions without a clear business case; justification rightly curbs such behaviours. Another example is situations of vigorous competition, where failing to react timely leads to failure; short-term feedback may be the only way for companies to remain competitive. Some other times, however, conventional actions and focus on short-term results lead to the neglect of long-term profit opportunities. This may be value-destroying in industries where innovation is discontinuous rather than incremental, that is, where uncertainty is high. Note that the relevance of uncertainty in particular industries changes over time. For instance, the future of the automotive industry is highly uncertain today, although it was arguably not such twenty years ago.

Hedge fund activism leads to a short-term bias, which is efficient in contexts of vigorous competition and incremental innovation, but may be inefficient when uncertainty is higher, for instance in situations of discontinuous or radical innovation. Large shareholdings cannot remedy this bias. Although it has been argued that institutional investors, who call the shorts in an activist's campaign, do not allow hedge funds to destroy value, this mechanism is not reliable. Because the portfolios of the majority of institutional investors are indexed, institutional investors do not have incentives to screen idiosyncratic choices. Moreover, institutional investors have to justify, too, which reinforces the short-term bias. Another way to tilt the balance between discretion and accountability away from the latter is controlling ownership. Although the vast majority of listed companies around the world have dominant shareholders, the latter do not always control enough votes to fend off activists. As a result, the controller's decisions and strategies may be challenged by activist minority shareholders, especially in Europe where minority shareholder rights have become extensive over the past two decades.

Corporate law should enable companies to choose and adapt the balance between managerial discretion and accountability depending on

their circumstances. The most straightforward legal tool to affect this balance is dual-class shares, which allow voting rights and cash flow rights to be disproportionate. In the presence of dual-class shares, the management can secure leeway simply by holding super-voting shares in a sufficient proportion as to outvote the holders of the remaining, lower-voting shares. Securing leeway in this fashion is increasingly common for IPO companies, such as Google. But the phenomenon is larger. In the U.S., for instance, 10% of the main stock market indices are represented by dual-class companies.

Securing leeway by introducing dual-class shares is much more complicated for companies which are already listed. Dual-class recapitalizations with super-voting stock are prohibited by the exchange rules in the U.S., and are not a viable technique to enhance the voting rights of the management or the controlling shareholders in other European jurisdictions.

The midstream introduction of control-enhancing mechanisms, such as dual-class shares, should be allowed under the following rules. First of all, managers or controlling shareholders should be allowed to issue super-voting stock to themselves. Secondly, non-controlling shareholders, who will be headed by institutional investors, should be able to veto the transaction. As confirmed by the recent case law of Delaware, an effective cleansing of conflicted interest transactions requires a combination of independent advice (special negotiation committee) and a majority-of-the-minority (MOM) shareholder vote. Institutional investors' veto is crucial to enable a negotiation over the price of super-voting shares. This price reveals how much leeway institutional investors are willing to give the management. Thirdly, the control enhancement should be temporary, i.e. expire in a number of years. The purpose of this default sunset clause, which companies could opt out of, is to avoid negotiation breakdown. When dual-class shares are established for an indefinite time, the price of the super-voting shares incorporates the value of control, which may be hard to agree upon for companies that are already public (as opposed to IPO companies).

This solution is preferable to other ways to grant management leeway, as put forward by academics and policymakers. One alternative would be to curb hedge fund activism across the board. However, hedge fund activism is efficient in some contexts, particularly for companies that benefit from short-term feedback. A second alternative is loyalty shares. Although in theory loyalty shares are meant to support long-term ownership, in practice they have been used by controlling shareholders as a substitute of dual-class shares. The main disadvantage of loyalty shares from this standpoint is that a controlling shareholder may introduce them unilaterally, i.e. without a MOM vote, which deprives institutional investors of an effective veto right on changing the distribution of powers. Finally, the solution being advocated fares better

than the imposition of mandatory sunset clauses on every dual-class shares arrangement, which is popular today both in the academic circles and in the policy debate. The latter approach exclusively focuses on how to discontinue dual-class shares when they have become inefficient. Our concern is broader: we worry also about how to introduce control enhancement when this is efficient. Allowing dual-class recapitalizations subject to a veto by institutional investors addresses both problems. On the one hand, it allows the management to contract for leeway in the midstream. On the other hand, it sets as default rule that dual-class shares are temporary, which is in line with the circumstance that control enhancements could be reintroduced when needed.