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THE INVENTION OF CORPORATE GOVERNANCE

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ABSTRACT

The analysis of corporate governance begins with a central feature of modern capitalism—the separation of ownership and control in large corporations—first empirically documented by Berle and Means (1932). Such separation entails several agency problems reflecting conflicts between managers and shareholders, such as self-dealing by managers, low effort, consumption of perquisites, and excessive growth and diversification. Berle and Means saw self-dealing as the central agency problem and stressed the law as the fundamental mechanism of addressing it. Jensen and Meckling (1976) considered the consumption of perquisites and emphasized private mechanisms, such as financial incentives for managers, to counter wasteful perks. Jensen (1986) instead focused on excessive growth and diversification, which led him to count on leverage and takeovers. The combination of public corporate governance mechanisms, mostly the law, and market governance shaped both theory and practice.

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I. Introduction

In an oft-quoted passage, Adam Smith (1776) wrote:

The directors of such [joint stock] companies, however, being the managers rather of other peoples' money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. (p. 700)

This brief passage raises many questions. What is the nature of what came to be known as the agency problem? Is it just low effort, or is there more? How prevalent is the separation of ownership and control, where managers are put in charge of other people's money? What are the benefits of such separation, and what are the costs, which presumably are not so high as to bring the capitalist system to a halt? And which mechanisms, either public or private, mitigate this cost? Despite Smith's pessimism, the "other" people whose money corporate managers control have usually gotten it back, often with a handsome return. This, after all, is where economic growth comes from.

The issues Smith raised eventually turned into a field of study and practice known as corporate governance. The separation of ownership and control entailed substantial agency costs. The early writers, most prominently Berle and Means (1932), saw the law as the best hope for containing these costs. Jensen and Meckling (1976) instead brought market rather than public solutions to the forefront of the analysis, two centuries after Smith. The interplay of public and private solutions shaped the field as we know it.

We divide our analysis into seven sections. In Section 2, we begin with a discussion of agency costs, and of how different writers thought about them. These costs come in many forms, from low effort mentioned by Smith and central to modern research on incentives, to

the consumption of perquisites, to excessive growth and diversification, to outright expropriation of investor wealth. How corporate governance solves agency problems turns critically on what agency costs happen to be.

In Section 3, we discuss the first classic of corporate governance, Berle and Means (1932) *The Modern Corporation and Private Property*. Berle and Means were the first to document systematically the extent of separation of ownership and control in large US corporations. As Smith and others have surmised, people running major companies, unless they are founders or their heirs, often own at most a percent or two of equity, so they are very different from proprietors. Unlike for Smith, however, for Berle and Means the central problem of corporate governance is not insufficient effort, but rather self-dealing – the diversion of corporate resources for the private benefit of the controlling shareholders or managers. Berle and Means stress public solutions, most importantly the law, to limit self-dealing by such controlling shareholders or managers. They see common law in the US, as practiced by the states, as good but insufficient for meeting the challenges of governance. Their book is the manifesto for strengthening legal protection of investors, especially through securities laws enacted shortly after the book was published.

The Berle and Means narrative of corporate governance dominated American views for the next forty years. Some writers, such as Baumol (1959), focused on other agency costs, such as sales maximization and excessive growth. But what prevailed is Berle-and-Means suspicion of markets and their emphasis on public solutions.

All of this changed as part of the Chicago Economics Revolution, inspired by Hayek, Friedman, and Coase, which replaced the Depression-era and postwar statism with market solutions. As we discuss in Section 4, in corporate governance this revolution was led by Jensen and Meckling (1976). They start with separation of ownership and control, stress perquisites as the fundamental agency problem, but then point to many market solutions that mitigate agency costs. These include product market competition, governance by creditors, managerial incentives, corporate boards, accounting rules that force disclosure of information, and crucially – following Manne (1965) – the market for corporate control. Jensen and Meckling see agency costs as unavoidable but bring up the many market mechanisms that contain them. Unlike Berle and Means, they see no role for the state.

The decade of the 1980s witnessed a tremendous takeover boom, during which 143 or 28 percent of the Fortune 500 companies lost their independence (Shleifer and Vishny 1991). Through the *Journal of Financial Economics*, Jensen championed the empirical study of market solutions to corporate governance problems, especially takeovers. What much of this work shares is the embrace of market effectiveness in promoting efficiency.

In the middle of the takeover boom, Jensen's own thinking on market governance turns from Pollyannaish to frustrated. Jensen (1986) moves away from the perquisites model of agency costs to excessive growth, empire building, and overdiversification. This leads him to propose a new view of corporate debt as the mechanism for forcing managers to disgorge rather than waste free cash flows. The next step is to embrace leveraged buyouts (Jensen 1989), later known as private equity, as the more efficient organizational form. Jensen's (1993) Presidential Address to the American Finance Association comes back to the

fundamental role of market solutions – in this case corporate takeovers and LBO's – to meeting the challenge of corporate governance.

Jensen's work fundamentally shaped the field. Literally thousands of papers documented, described, and explained the market mechanisms of corporate governance following in his footsteps. But several issues remained open. In Section 5, we offer a highly selective overview of a few, including the theoretical and empirical work on the market for corporate ownership and control, and a revisit of the social objectives of the firm.

In Section 6, we look briefly – with deep awareness of the impossibility of establishing causality – on the consequences of the Jensen-Meckling revolution for the world. We show that corporate governance has become a key phrase in media discussions of business. We describe the growth of leveraged buyouts and private equity. We take a brief look at executive compensation and the growth of high-powered incentives. The revolution had a lasting impact. The radical ideas of the 1970s became conventional wisdom among both academics and practitioners a few decades later.

Section 7 concludes with the major lessons we learned. Corporate governance today is a mature field, with substantial empirical evidence supporting its main tenets.

II. The Nature of Agency Problems

The analysis of corporate governance typically focuses on large joint stock companies controlled by a manager and owned by a substantial number of outside

shareholders with minimal influence on corporate decisions. Such companies have existed for centuries but became prominent in the 19th century in the UK, and a bit later in the US, so much so that they came to dominate economic activity. The growing role of these firms led to the obvious question: does separation of ownership and control entail agency costs, created by the divergence of interests between managers and shareholders?

Early writers on agency costs answered with a resounding yes (e.g., Marshall 1919). Their descriptions fall into four broad categories. The first is lack of effort, also known as laxity or negligence or easy life by the managers, resulting from their inability to earn full returns on their effort, since such returns mostly accrue to shareholders. This type of agency costs concerned Smith (1776), but also Marshall (1919) and many others.

The second type is perquisites. The idea, also in Marshall (1919), is that corporate insiders make choices that please them for reasons of comfort or prestige or enjoyment, but that are paid for by investors. Marshall is clear that a sole proprietor of a business might regularly make many non-value maximizing choices, but he is fine with that because the proprietor pays for them. Not so for managers, whose perks shareholders pay for.

A third type of important agency costs is sales maximization, over-investment, excessive growth, or diversification. Marshall already mentions this, but the idea was most prominently developed by Baumol (1959), who however does not see the growth focus as a problem. Excessive growth may be seen as a form of perks, in that it may benefit insiders who seek power, or influence, or glory, or respect, or even higher compensation that comes with larger firm size, even if it does not serve shareholders.

A final type of agency costs is outright expropriation of outside investors by managers or controlling shareholders, also known as self-dealing or tunneling. Tunneling can take the form of outright theft of corporate wealth, targeted security issues, excessive compensation, minority freezeouts in takeovers or equity issues, or related party transactions whereby the controller buys goods or assets of a publicly held firm at excessive prices from an entity he owns or sells goods or assets of such a firm at too low prices to an entity he owns. In all these examples, the controllers benefit themselves at the expense of outside investors.

A brief tour through some of the 20th century corporate governance studies highlights the agency problems that various authors focus on. The aging Marshall (1919) is a bit vague, but hints at each of the agency problems we mentioned, including effort, perks, excessive growth, but also expropriation. Ripley (1927) and Berle and Means (1932), the protagonists of the next section, are instead focused on investor expropriation and how to stop it. They are worried about theft not effort. Williamson (1964) and Galbraith (1967) summarize the post-war conventional wisdom, and both find space for each of tunneling, effort, empire building, and perks. Modern formulations of incentive theory, such as Ross (1973), Stiglitz (1975), and Holmstrom (1979), go back to effort. They are interested in effort elicitation in general, rather than specifically in corporate governance.

As we detail in Section 4, Jensen and Meckling (1976) focus on perks. It is not clear whether this is an analytical convenience or an empirical conviction, but much of their analysis depends on that formulation. Jensen (1986) switches gears, and focuses Baumol-style on excessive growth and empire building. These distortions in corporate choices play a much larger role in his work than either effort provision or investor expropriation.

Table 1. Early Works on Agency Problems

Author	Title	Type
Smith (1776)	Wealth of Nations	Effort
Marshall (1919)	Industry and Trade	Effort, tunneling, empire building
Ripley (1927)	Main Street and Wall Street	Tunneling
Berle and Means (1932)	The Modern Corporation and Private Property	Tunneling
Baumol (1959)	Business Behavior, Value, and Growth	Empire building
Williamson (1964)	The Economics of Discretionary Behavior	Perks, empire building
Galbraith (1967)	The New Industrial State	Tunneling, perks, empire building
Manne (1965)	Mergers and the Market for Corporate Control	Effort
Ross (1973)	The Economic Theory of Agency: The Principal's Problem	Effort
Stiglitz (1975)	Incentives, Risk, and Information: Notes Towards a Theory of Hierarchy	Effort
Holmstrom (1979)	Moral Hazard and Observability	Effort

Notes: This table summarizes early discussions of agency problems. The first column shows the author and publication year. The second column shows the title. The third column shows the types of agency problems discussed.

III. Berle and Means: The Supremacy of the Law

Berle and Means (1932) is the first serious scientific study of corporate governance.

Before getting into details, we note that this honor partly belongs to William Ziemba Ripley (1927), a colorful Harvard economics professor (and the original occupant of a house in Newton, MA where one of the present authors has lived for the past 35 years). Ripley's book, "Main Street and Wall Street" --he invented that expression -- is in part a serious treatise, in part an expose of the evils of Wall Street financiers and their tunneling of firms. To quote Galbraith (1967) on Ripley and Berle:

Professor William Z. Ripley of Harvard, the leading authority on the corporation in the twenties, warned President Coolidge that "prestidigitation, double-shuffling, honey-fugling, hornswoggling, and skullduggery" were threatening the entire economic system. Adolph A. Berle Jr., Ripley's successor as the prime authority on the corporation, concluded that the mature corporation accorded no effective rights to the owners of the enterprise. There could, in consequence, be only one of two results. Managers would become trustees,

properly supervised, on behalf of the “inactive and irresponsible” owners. Or they would “operate it in their own interests and divert a portion of the asset fund to their own uses.” There would develop “a corporate oligarchy coupled with a probability of an era of corporate plundering.”

Both Berle and Means (1932) and Galbraith (1967) acknowledge their debts to Ripley.

Berle and Means (1932) made four contributions to the study of large corporations. First, they documented empirically the patterns of separation of ownership and control, by putting together the lists of largest shareholders and their holdings and showing that top managers were often trivial shareholders. They also described ownership structures, such as pyramids, that further separated ownership from control. The term “Berle and Means corporation” refers to firms with low management holdings and became the default view of corporate ownership and control.

Second, Berle and Means saw diversion (or tunneling, or theft) of corporate assets by managers or controlling shareholders as the principal agency problem. “If we are to assume that the desire for personal profit is the prime force motivating control, we must conclude that the interests of control are different from and often radically opposed to those of ownership; that the owners most emphatically will not be served by the controlling group (p. 114)”. “When their holdings amount to only such a fractional percent as the holdings of the management in management-controlled corporations, profits at the expense of the corporation become practically clear gain to the persons in control and the interests of profit-seeking control run directly counter to the interests of the owners (p. 115).” Berle and Means give many examples of such conflict and diversion of profits.

Third, Berle and Means do not put much trust in markets to address conflicts of interest. They briefly discuss external fundraising as a disciplining force, but do not see this as sufficient. Rather, they emphasize the law protecting shareholders as the best hope for governance. Logically, this stands to reason. If the agency problem is overexpansion, or perquisites, or low effort, then incentives would be effective, since the benefits to the managers with low ownership stakes are modest. A manager spending \$1 on unnecessary investments or perks might get only a few cents worth of private benefits such as prestige, which even a modest ownership stake or incentive pay package would cause him to internalize. But the benefit of diverting a \$1 of profits to one's own pocket is exactly \$1, and it takes powerful and expensive incentives to discourage such diversion. For Berle and Means, self-dealing can only be stopped by the law.

Indeed, Berle was a law professor, and most of the book is devoted to the ability of common law to control investor expropriation. "We are thus led to conclude the strength of law in this regard is the only enforceable safeguard which a security owner really has" (p. 197). Although Berle and Means praise prevailing law, they do not feel it is up to the task against the insiders. Their book is often seen as the manifesto for securities laws in the US, although the authors do not mention them directly.

The Berle and Means take on corporate governance dominated academic thinking for the next 40 years. It may or may not have been central to the passage of securities laws. Their pessimism in the depths of the Great Depression was perhaps in part countered by the extraordinary performance of the US economy after the war. Berle remained skeptical and, according to Lehmann (2019), moved in the direction of greater state control. Yet the

intellectual response had to wait. It came in the 1970s, as part of the Chicago assault on government control of the economy. In the special issue of the *Journal of Law and Economics* on the 40th anniversary of Berle and Means, Stigler and Friedland (1983) felt the book is important enough to really rip it to shreds.

IV. Jensen: The Power of Markets

Hayek's (1944) manifesto precipitated a half-century intellectual response to the Depression-era and post-war skepticism about capitalism and markets. Much of that response centered at the University of Chicago, but Columbia and Rochester played major roles as well. Friedman (1959) and Lucas (1972) in macroeconomics, Coase (1960) in law, Becker (1956) and Mincer (1974) in labor, Harberger (1962) in public finance, Stigler (1958) in industrial organization, TW Schultz (1964) in development, and Modigliani-Miller (1958) and Fama (1965) in financial economics all transformed their disciplines. The common theme of this research is the recognition of market solutions and competition as sources of efficiency and prosperity. Another common theme is emotional hostility to the statist ideas this research replaced. Economics would never be the same.

In corporate governance, this transformative role fell to Jensen and Meckling (1976) who created the field in its current form. The paper places corporate governance in a market setting and stresses private mechanisms of controlling agency costs. Shareholders are no longer ignorant victims of managers, to be saved by the state and the law. They monitor entrepreneurs-managers, who in turn use bonding devices to get funding on better terms.

The paper disparages Berle and Means, referring to them only once as “popularizers.” (Recall they were the first empiricists in the field.) In his Presidential Address to the AFA in 1993, Jensen cites dozens of studies, but not Berle and Means.

Jensen and Meckling (1976) present a formal model of corporate ownership inspired by Alchian and Demsetz’s (1972) idea that corporation is a nexus of contracts. The agency problem they model is the consumption of perquisites by managers, such as “physical appointments of the office, the attractiveness of secretarial staff, the level of employee discipline, the kind and amount of charitable contributions, personal relations (“love”, “respect”, etc.) with employees, a larger than optimal computer to play with, purchase of production inputs from friends, etc.” (p. 312). They are not interested in shareholder expropriation – perhaps because they feel this problem is solved in the US by the time they are writing. Nor, except for a brief mention in the conclusion, are they interested in the law. This is a major departure from Berle and Means.

Instead, Jensen and Meckling stress private solutions to agency problems. They see agency costs as unavoidable: no solution eliminates them completely. A firm that needs outside capital to invest can issue equity, but that diminishes the equity stake of the entrepreneur. Such dilution in turn raises the divergence between the benefits of perks and their costs to the entrepreneur, since outsiders pay for some of the benefits (and all of them as manager’s stake approaches zero). This firm can also issue debt, but debt entails potential costs of financial distress and creates another agency problem – the incentive for the manager to take excessive risk since the downside falls on the creditors.

Jensen and Meckling derive an optimal capital structure that minimizes total inefficiencies, including perquisites, excessively risky investments, and costs of financial distress. As with Berle and Means, who saw the law as the remedy for self-dealing, Jensen and Meckling's focus on perquisites leads them to solutions that are appropriate for that problem. For if perks are the problem, then management incentives, some shareholder oversight, the need to return to capital markets, all work to discourage excess spending on perks. The solutions fit the problem.

Perhaps more important than the specific modeling assumptions, Jensen and Meckling redefine corporate governance as private solutions to containing agency costs. These solutions, both in their paper and later work, include product market competition, incentive contracts for managers, corporate boards, shareholder voting, the need to return to capital markets to raise additional funds, contractual governance by debt holders, disclosure systems, competition between managerial teams both to attain reputations for excellence and probity and to control more assets, and takeovers. Like Moses with the tablets, corporate governance received its commandments for decades to come.

Indeed, research in corporate finance since Jensen and Meckling (1976) has been dominated by their ideas. Fama and Jensen (1983a,b) expanded the Jensen Meckling analysis, which focused on the relationship between an entrepreneur and outside investors, to the study of large corporations and other organizational forms such as non-profits, and described managerial decisions as checked by corporate boards and other approval mechanisms. Fama (1980) stressed the importance of managerial reputations and competition between management teams in controlling agency problems. Murphy (1985)

and others whose work is summarized by Jensen and Zimmerman (1985) argued that executive compensation aligns the interests of managers and shareholders.

The Jensen and Meckling paper was written at the very beginning of a takeover boom that, during the 1980s, reshaped American corporate landscape, including the patterns of corporate ownership and governance. On the one hand, many of largest American firms were taken over, and had their management teams replaced, by other firms or independent investors using debt to finance acquisitions. On the other hand, incumbent management teams adopted many anti-takeover devices designed to stop these challenges. As the takeover boom expanded, so did research about it. In 1983, the Journal of Financial Economics published a set of papers on the market for corporate control. Jensen and Ruback (1983) summarized the evidence and presented a highly optimistic picture of the takeover boom in the spirit of Manne (1965), which saw takeovers as replacement of inefficient management teams by better ones, and resistance to takeovers as attempts by incumbent managers to keep their rents.

Motivated by the takeover boom and aggressive resistance by incumbent managers to takeovers, Jensen (1986) moves beyond the Jensen-Meckling model. The agency problem he focuses on is over-expansion and over-diversification by large corporations motivated by power, fame, and increased management pay, since pay is empirically related to size (Murphy 1985). Jensen criticizes the prevalent corporate governance mechanisms, such as incentive pay and boards of directors, as serving rather than disciplining the incumbents and thus failing to reduce agency costs. Instead, he focuses on governance tools that force firms with modest investment opportunities to disgorge free cash flows.

The first of these tools are dividends, which serve the purpose of returning cash flows to shareholders (Easterbrook 1984). But Jensen (1986) further identifies a new role for debt as a governance device: it forces managers to return free cash flow to outside investors, in this case creditors who have bankruptcy and other threats if not paid back. This powerful mechanism is reflected in Jensen's logic in the rise of leveraged buyouts – debt-financed acquisitions combining leverage and high ownership by insiders – in the mid and late 1980s (Kaplan 1989). Both, of course, are powerful motivating devices.

Jensen's (1986) rethinking of corporate governance again links the nature of the perceived agency problem to its solution. Just as Berle and Means focused on tunneling and saw the law as a remedy, and Jensen and Meckling (1976) focused on perquisites and saw incentives as the solution, Jensen (1986) focuses on excessive investment by highly profitable firms with limited growth opportunities and wants them to disgorge free cash flows. With incentive pay failing in its role, dividends and leverage emerge as the logical solutions to this agency problem.

Jensen stayed with this line of thinking the next several years. In 1990, he argued empirically, with Kevin J. Murphy (1990), that incentives coming from management compensation contracts are extremely weak, because a typical CEO with a low ownership stake in the company benefits only to a miniscule extent from changes in shareholder wealth. This again departs from earlier work, such as Murphy (1985) and Jensen and Zimmerman (1985), which assessed incentive pay more optimistically.

The Jensen-Murphy logic turns heavily on the cost of perquisites being small in large companies (Baker and Hall 2004), or a high value of perquisites or glory if the costs are more substantial. The same CEO with a small percentage stake may have most of his personal wealth in the shares of the company, as is surely often the case. Imagine a company with a \$1 billion market capitalization, in which the CEO owns 5% or \$50 million. Suppose the CEO is considering a \$100 million investment that will pay off zero – a clearly bad opportunity he would only pursue for the sake of perks or empire-building. If the CEO's wealth is entirely in the shares of the company, his personal cost of this investment is proportional to that to the shareholders, or 10% of his wealth. Unless the perks or empire building are worth more than \$5 million, which seems implausible, the investment will not be made. Although US data on manager wealth is scarce, Elsiila et al. (2013) for Swedish firms find that 45% of average CEO's wealth is in the shares of the company they run. Value-destroying growth seems less plausible if managers lose wealth in proportion with other shareholders.

As the takeover boom and managerial resistance to it progressed, Jensen took his arguments further in both academic and public spheres. In "Eclipse of the Public Corporation", Jensen (1989) argues that the dominant organizational form of a widely held publicly traded corporation has become obsolete in solving agency problems because incentives it provides to top managers are feeble. A highly leveraged corporation such as an LBO would do a better job and is set to replace public firms, both because it allowed CEO's to own higher fractional ownership stakes, and because debt would force the disgorgement of free cash flows. Jensen (1993) takes this reasoning further. He sees the takeover boom as the Third Industrial Revolution in America. Like the consolidation of industry in the late

19th century, the boom would force the restructuring of American firms, cut out fat and inefficiency, and precipitate exit. It would replace the lazy and uncompetitive firms of the post-war era protected by American economic leadership and political dominance in an open world with leaner and meaner organizations.

A decade later, Jensen's research on corporate governance took one more turn. Early in his career, Jensen became one of the staunchest supporters of the efficient markets hypothesis, himself making important contributions (Jensen 1968, Fama et al. 1969). "I believe there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis," he wrote (Jensen 1978).

Yet witnessing the internet bubble of the late 1990s, he reconsidered. In "Agency Cost of Overvalued Equity", Jensen (2005) denounces stock market overvaluation for wreaking havoc in incentive systems so essential for effective governance. Corporate managers of course are happy with overvalued equity, because it brings them higher compensation and higher valuations of their equity and options. To sustain the expectation of rapid earnings growth needed to keep stock prices up, managers then make bad investments and acquisitions that destroy long-run value (Moeller et al. 2005). They also manipulate earnings through dubious accounting practices and short-termism driven investments, buy back shares, and otherwise drive-up share prices. The very incentive mechanisms that Jensen saw as essential for good governance, such as compensation linked to equity prices and distributions of cash to investors, are hijacked to destroy value.

Jensen left an extraordinary legacy. He replaced the Berle and Means state-centered approach to corporate governance with a mosaic of market solutions, each of which by itself generated a vast literature probing its effectiveness. The term corporate governance is now associated with these private solutions. As his career evolved, so did Jensen's ideas about the effectiveness of alternative strategies of corporate governance. It is quite remarkable in retrospect to see the great scholar revising his earlier ideas in light of new evidence. We could use a bit more of that in finance.

V. Intellectual Follow-ups

The takeover boom of the 1990s eventually ended, but not the research on corporate governance. In this section, we offer an extremely selective summary of some of the highlights that we see as directly related to the themes we stressed already. These include five topics: 1) theoretical developments on corporate control, 2) an empirical revisit of the nature of the agency problems and the return of Berle and Means, 3) an empirical revisit of separation of ownership and control, 4) the role of debt in corporate governance, and 5) an increased interest in the objectives of the firm.

In their model of optimal corporate ownership, Jensen and Meckling (1976) assume that shareholders do not vote, and hence are powerless to defend their rights through voting mechanisms. But that left a key issue open: the market for corporate control is after all the consolidation of voting rights to gain the majority of votes and replace management. What is the role of shareholder voting in governance?

Following early insights of Easterbrook and Fischel (1983), fundamental answers to this question came from the theoretical work of Grossman and Hart (1986) on incomplete contracts, and subsequently Grossman and Hart (1988) and Harris and Raviv (1988) on optimal security design. Grossman and Hart (1986) explained why complete contingent contracts are infeasible in many settings, including the firm. Grossman and Hart (1988) and Harris and Raviv (1988) then applied this idea to corporate securities and argued that what defines these securities is not just cash flows they receive, but also the rights and powers they give their owners. For shareholders, these are voting rights. For creditors, these are the rights in bankruptcy or in violations of contractual debt covenants.

Of course, for corporate voting, individual voting rights are not particularly valuable because a small shareholder, just like a voter, has a trivial effect on the outcome of the vote. Yet unlike in the political domain, corporate votes can be traded, for instance when shares are traded, which makes it possible to accumulate enough votes to change outcomes (see, e.g. Shleifer and Vishny 1986). More broadly, this formulation opened the question of how best to package voting and cash flow rights together into securities. To address it, Grossman and Hart asked what agency problem needs to be solved. They introduced the concept of private benefits of control, a mix of perquisites and expropriation opportunities for the controllers. “These include synergy benefits realized by the acquirer, the return to being able to freeze out minority shareholders at a price below the value of their shares, perquisites of control, and in extreme cases the diversion of resources from the security holders to subsidiaries of management or the acquirer (p. 177).”

Grossman and Hart (1988) show that the most efficient security design links cash flow benefits of equity with voting rights. Since a vote is of little value to a small shareholder, if votes are not tied to cash flows a potential acquirer seeking control would bid only for votes. To get the acquirer to pay for the cash flows, it is efficient to tie them together with votes. This design forces an acquirer who only wants control to pay for the cash flow rights as well. One share one vote works best.

These ideas have major implications. Cash flows accruing to different types of claims are no longer their defining feature, but rather a byproduct of their powers. Shareholders receive dividends not because dividends define equity, but because votes give them power via proxy fights or takeovers. Creditors get paid not because interest defines debt, but because creditors can resort to bankruptcy to obtain control or pursue liquidation if a firm defaults. This research clarified the Jensen-Meckling intuition that capital structure is not separate from investment choices: it shapes the powers of different claimholders, and thus corporate investment and the value of the firm. The MM propositions are irrelevant.

The implications go much further. Once we think about “private benefits of control” as the agency cost, the question of what keeps them down comes knocking. Perhaps not surprisingly, the answer turns out to be the law – corporate law, securities law, bankruptcy law, etc. In the 1990s, it became possible to measure the laws protecting shareholders and creditors from insider self-dealing in different countries, and to connect these laws to tunneling and financial market development (see LaPorta et al. 1997, 1998, Djankov et al. 2007, 2008). This research found that countries in different legal traditions show different levels of investor protection, with common law countries generally exhibiting higher levels

than civil law countries, and consequently different levels of financial development, as measured by numbers of listed firms, valuations of debt and equity markets, and so on. The laws limiting self-dealing enable outside investors to get their money back, perhaps with a return, and thus enable firms to raise outside funds (Shleifer and Vishny 1997). After 60 years, we returned to Berle and Means.

These developments encouraged academics to revisit the question of whether the Berle and Means corporation, with managers in full control with virtually no cash flow ownership, and shareholders with all the ownership but no interest or capacity to exercise their rights, describe reality. Demsetz and Lehn (1985) and Morck et al. (1988) show that even among US Fortune 500 firms relatively concentrated ownership is not uncommon, usually in cases where founders or their descendants kept significant ownership stakes. Berle and Means corporations were dominant, but not universal.

Morck et al (1988) also show that, over much of the range, higher management ownership is associated with higher performance as measured by Tobin's Q, although at very high levels of ownership, where the controlling shareholders are not subject to any challenges, performance appears to decline. This suggests that complete control by a dominant shareholder, despite high traditional incentives, may spell trouble for minorities. Consistent with this evidence, Stulz (1988) shows theoretically the potential adverse effects of high insider ownership of control rights. More broadly, one cannot take the Berle and Means ownership structure, which Jensen and Meckling also embraced, as universal. Large shareholders and managers are often the same, and both can engage in self-dealing.

Such instances were relatively rare in the US, the focus of most of the research on corporate governance until the 1990s. The theoretical studies of ownership, control, and private benefits encouraged economists to look elsewhere. What they discovered is that in other parts of the world the Berle and Means corporation was truly exceptional. Rather, ownership was heavily concentrated among controlling shareholders, and control – through pyramids, shares with multiple classes of votes, and so on – was even more concentrated than cash flow ownership. Moreover, direct measures of the magnitude of tunneling, such as the premium on the market price of shares with superior voting rights, showed that private benefits of control are high, and higher in countries with poor investor protection (Zingales 1994, Johnson et al. 2000, Nenova 2003, Dyck and Zingales 2004). The Berle and Means corporation was an exception not the rule in Continental Europe, Latin America, Asia, Africa – nearly all countries that had financial markets (La Porta et al. 1999).

Nor is this all. As scholars began to look closer, they saw two further things. First, consistent with highly concentrated control and large control premia, the principal agency problem in much of the world was not the consumption of perquisites, lack of effort, or overexpansion – it was tunneling. The controllers of large corporations – through trading assets, issuing securities, changing capital structures and other means – worked hard to separate outside investors from their cash flows. In the words of a Belgian billionaire Albert Frere, “small minority shareholder, small fool; big minority shareholder, big fool” (The Economist 1998). While tunneling might have been successfully addressed in the US – in part by securities laws and in part by the fiduciary duty of managers to shareholders – it remained the central problem of corporate governance in much of the rest of the world.

This research led to an updated view of agency problems and equilibrium ownership structures. Perquisites seem minor compared to other agency problems. With poor legal protection of investors, the central agency problem is self-dealing by insiders. In that environment, dispersed ownership cannot be sustained in equilibrium because as Berle and Means feared minority shareholders are regularly expropriated. Ownership and control are concentrated in equilibrium, and financial markets are small. As legal protection improves, tunneling recedes, and ownership in equilibrium become more dispersed. The central agency problems become effort and over-expansion. The solutions to these problems (once legal protection is in place) are incentives and debt, just as Jensen has argued. There is a fundamental complementarity – not antagonism -- between private and public approaches to corporate governance, between Berle-Means and Jensen. Investors need legal protection from expropriation to provide capital, as well as private governance mechanisms to make sure this capital is used well. Different agency problems require different but complementary solutions.

We have also learned a great deal about governance by creditors. Traditional debt contracts involve physical collateral, which is seized by creditors when debt is not paid (Hart and Moore 1994). Such contracts are extremely inefficient when liquidation values of assets are substantially below market values (Shleifer and Vishny 1992). They also do not work when self-dealing opportunities are unlimited because debtors can transfer collateral out of the firm, unless it is something unmovable like land or real estate. As investor protection (and accounting methods) improves, however, so do opportunities to write debt contracts based not only on physical assets, but also on cash flows. Creditors can then introduce

conditions or covenants into debt contracts and monitor the firm for violations (Diamond 1984, Aghion and Bolton 1992, Dewatripont and Tirole 1994). The evidence shows that such governance by creditors can be effective (Chava and Roberts 2008, Roberts and Sufi 2009, Nini, Smith, and Sufi 2009, 2012), and that earnings-based borrowing is becoming common for large firms (Lian and Ma 2021).

One further recurring issue in corporate governance is the objectives of the firm. Financial economists have historically accepted Friedman's (1970) argument that the objective of the firm should be to maximize profits or market value. During the 1980's takeover boom, this objective was questioned from the perspective of stakeholder interests, raising the possibility that managers should attend to the welfare of employees and other constituencies (e.g., Shleifer and Summers 1988). Jensen (2002) confronts these concerns and argues forcefully that multiplicity of corporate goals would lead to chaos, and dilute accountability of corporate managers. He also claims that properly attending to the interests of stakeholders would if anything serve to increase the value of the firm.

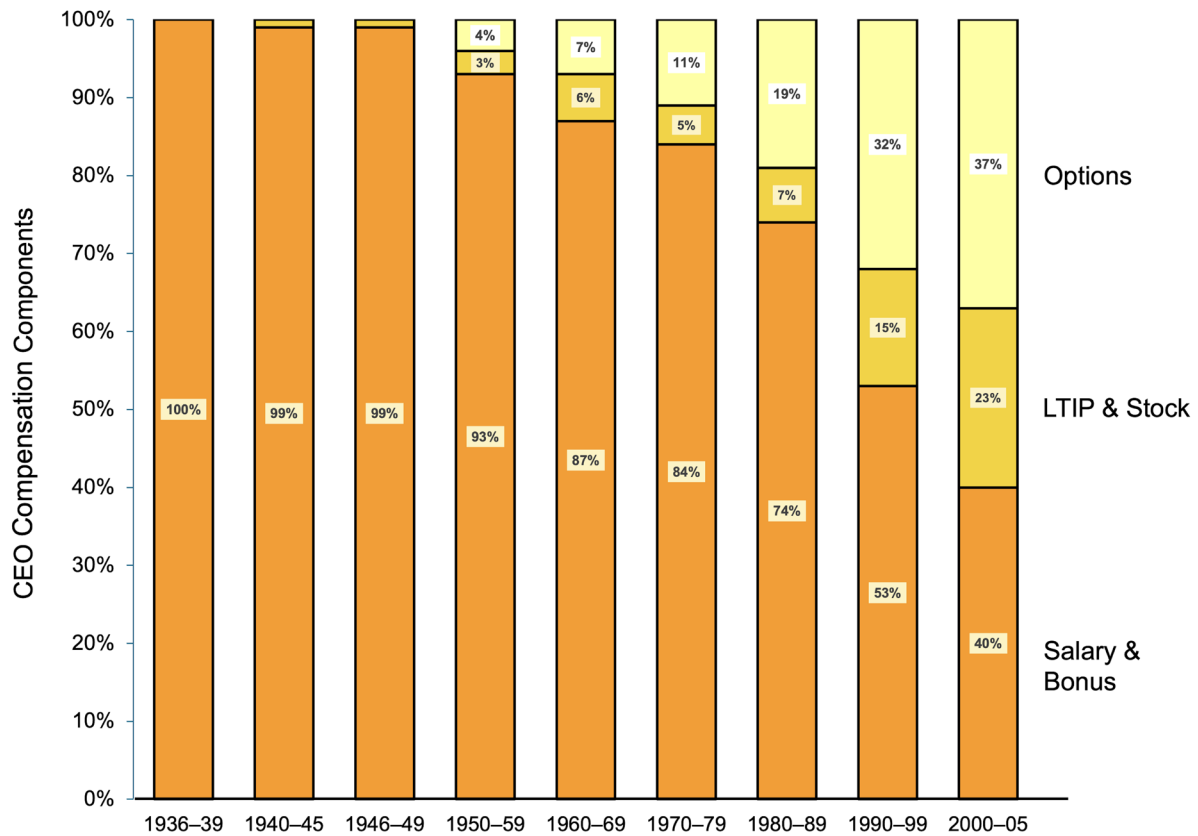
More recently, inspired by the ESG movement, some have argued that firms should maximize the goals of their shareholders, even if these goals differ from value maximization (Hart and Zingales 2022). This argument is still evolving. For if shareholders indeed have goals other than value maximization, such as environmental or labor policies, they would pay more for the shares of a company pursuing their goals, leading to higher market values. It has been challenging to come up with shareholder goals that entail deliberate market value reductions. Much of the evidence on shareholder activism suggests that value maximization remains the primary objective of shareholders (Brav, Jiang, and Kim 2015).

VI. Impact

The impact of the two classics in corporate governance, Berle and Means (1932) and Jensen and Meckling (1976), on academic research has been immense. But so, crucially, has been their impact on the world, in their respective domains. We have already mentioned securities laws in the US. We do not have direct evidence, but Berle takes some credit in the preface to the 1968 edition of their book for these laws.

Jensen and Meckling and Jensen's subsequent work have likewise had an enormous impact on private corporate governance. We can provide a few illustrations. First, management pay changed radically in the United States. Figure 1, taken from Edmans, Gabaix, and Jenter (2017), uses data from Frydman and Saks (2010) and shows the share of incentive pay in total management pay in the form of stock options or share grants following good performance. Equity-based incentive pay increased dramatically from non-existent in the early 20th century to most compensation in the sample firms by the 21st century. These increases in incentive pay often came on top of salaries, rather than as a substitute as recommended by Jensen and Murphy (1990). Jensen recognized some of the adverse consequences and manipulations entailed by high-powered incentives. Nonetheless, the impact of his work on management pay is clear.

Figure 1. The Structure of CEO Compensation



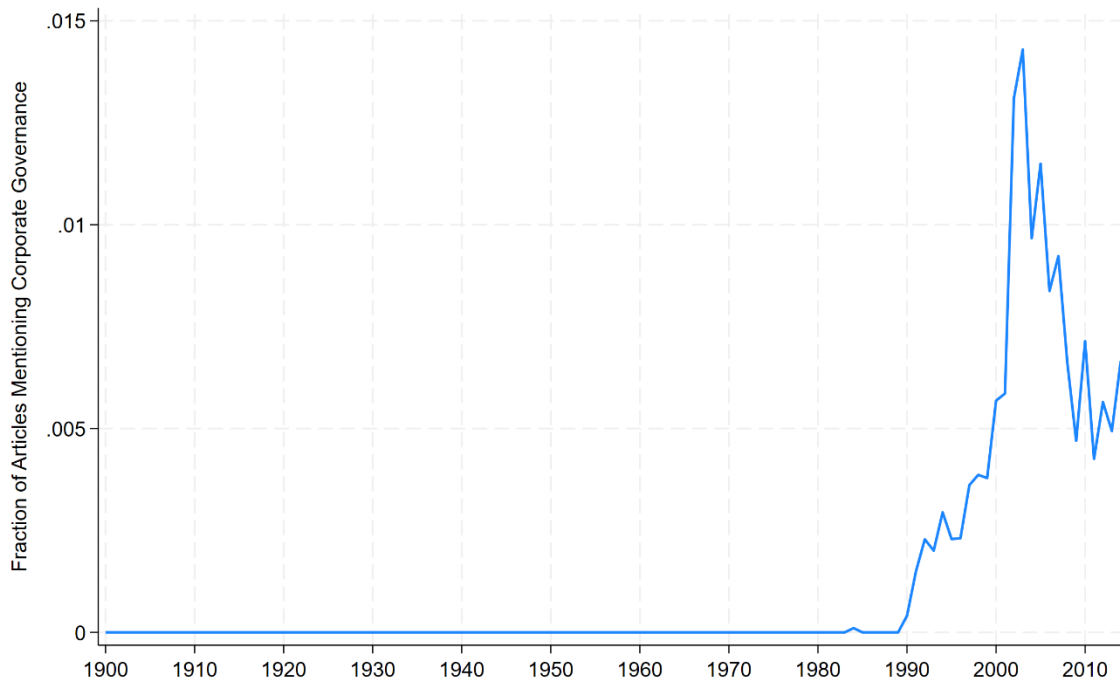
Notes: This figure from Edmans, Gabaix, and Jenter (2017) shows the average composition of CEO pay in the 50 largest firms in 1940, 1960, and 1990 (for a total of 101 firms). The figure shows salaries and current bonuses, payouts from long-term incentive plans (including the value of restricted stock), and the grant-date values of option grants (calculated using Black-Scholes).

Second, leveraged buyouts grew substantially from the cottage industry to an active private equity sector with a massive deal volume. Private Equity did not replace publicly traded firms, as Jensen (1989) predicted, but the deals reached \$350 billion in 2019, about 0.6% of GDP and roughly comparable to the M&A volume -- surely a significant impact.

Finally, Figure 2 shows the fraction of articles published in *The Economist* that contains the phrase “corporate governance” or “corporate control.” Since the 1980s, these

two phrases have become much more frequent in the coverage of business. The core topics of Jensen’s work have prominently entered the public domain.

Figure 2. Articles in *The Economist* Mentioning “Corporate Governance”



Notes: The figure shows the fraction of articles published in *The Economist* every year that contains the phrase “corporate governance.” Data are shared by Zhang (2018).

VII. Conclusion

A century after corporate governance has been invented as a field, large firms are as important as ever (Kwon, Ma, and Zimmermann 2024), and so is their governance. Thankfully, we learned many lessons. First, the solutions to corporate governance challenges depend critically on which agency problem matters. In this regard, managerial effort and consumption of perquisites have receded as plausibly important agency

problems, whereas managerial self-dealing and empire building have gained prominence. Corporate governance aims to solve the latter problems.

Second, the principal solution to the problem of self-dealing is the law. Legal protections of investors enable firms to raise external funds and allow firms to issue debt and equity and grow. Without such protections, ownership remains concentrated, firms are smaller and closely held, and capital markets are stunted. We owe these ideas about public corporate governance to Berle and Means.

But the law is not enough. Left to their own devices, corporate managers can still pursue self-serving strategies. They need market discipline. Such discipline is provided by the private mechanisms of corporate governance, such as incentive pay, leverage, and the market for corporate control. We owe to Michael Jensen the central ideas in this domain.

Between the public mechanisms of Berle and Means, and the private mechanisms of Jensen, the corporate governance problem in the US has been reduced, especially compared to the rest of the world. There are surely major remaining problems, such as earnings manipulations, cutting corners, short-termism, and other distortions from high powered incentives schemes, which Jensen himself acknowledged. Yet we see governance working, as seen both in high profitability and market valuations and in the shorter tenure and faster aging of corporate executives (Borgschulte et al. 2024). In many other parts of the world, there has been considerable progress, but much more remains to be done. The central point, however, is that at least in this sphere, we roughly understand how things work. And we owe this knowledge to the amazing inventors of the field.

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