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Contents

The Neglected Role of Justification under Uncertainty in Corporate Governance and Finance

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ABSTRACT

A big corporate governance debate concerns the corporation's time horizons and the balance of power between shareholders and managers. In response to pressure from shareholder activists – typically activist hedge funds – companies are, some say, becoming too short-term. If this is true, shareholders and the greater society may be being harmed. We argue here that this may reflect a heretofore neglected facet of decision-making: an actor's accountability and her anticipated need to justify decisions in the case of a bad outcome.

Our account does three novel things. First, we demonstrate that the need to justify is pervasive. Our account identifies a type of agency cost, "justification costs," resulting from decisions motivated by justification. Second, to our knowledge, the relationship between these sorts of agency costs and more traditional agency costs has not been considered. Reducing traditional agency costs typically means increasing accountability and the consequent anticipated

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need for justification; in contrast, reducing costs of justification generally means increasing managerial leeway, which might increase traditional agency costs. Third, we introduce a role for uncertainty. We show that under conditions of low(er) uncertainty, more accountability does not necessarily increase justification costs but does reduce traditional agency costs. But under conditions of uncertainty, accountability increases justification costs, potentially in an amount greater than any reduction in traditional agency costs.

We propose a mechanism by which managers and stockholders can agree on granting managers some leeway for a specified period of time, in the form of "Control-Enhancing-Mechanisms" (CEMs). A CEM may or may not condition continuing leeway during the period on management's meeting certain agreed-upon conditions. We consider how our argument as to the existence of justification costs might apply in some private and public financial contexts, and suggest some solutions in those contexts as well.

1

Introduction

The big corporate governance debates nowadays concern the corporation's time horizons, and the balance of power between shareholders and managers.[1] In response to actual and anticipated pressure from shareholder activists – typically, activist hedge funds – companies are, some say, becoming too short-term, shunning research and development expenditures, and hobbling their prospects (and perhaps their continued existence) by borrowing, paying out their available cash, raising cash via sales of their divisions, and otherwise excessively reducing expenditures, in order to distribute big sums quickly to shareholders.

We are now nearly recovered from a financial crisis in which housing prices increased precipitously and then collapsed, in part – perhaps in significant part – because many money managers made huge bets on housing as such bets became 'hot' and sought after, not doing enough of their own research but instead simply trying to make sure they could get as much as they could of the latest AAA rated issuance.

[1] These questions have been at the core of the corporate governance debate for decades. See M. Becht, P. Bolton, and A. Röell, "Corporate Law and Governance", in A. M. Polinsky and S. Shavell, eds., *Handbook of Law and Economics*, Vol. 2 (North-Holland, 2007).

If these stories are credited, private actors – shareholders and clients of the money managers – as well as the greater society are being harmed. We argue here that these stories, with their short-termism and herding, may reflect, at least in part, a heretofore neglected facet of decision-making: an actor's accountability, and consequently, her anticipated need to justify her decision in the case of a bad outcome. Two examples quickly summon up the intuition, albeit in contexts far from the corporate and finance realm: "defensive medicine" and assessments of dangerousness of mental patients being considered for release. In the first case, the anticipated need for justification, especially in a case involving unusual symptoms, can yield excessive and costly testing.[2] In the second case, it can yield continuing confinement of a person who should not have been confined, since the decision-maker suffers far more releasing a dangerous person than continuing to confine a non-dangerous person. In both cases, the anticipated need for justification yields a decision that is based on something other than the best available assessment on the merits. We argue here that in the corporate and finance spheres as well, justification is a neglected factor in decision-making. Particularly under conditions of uncertainty, justification-motivated decision-making can impose both agency costs and social costs. We focus mostly on the corporate realm, but also discuss some implications for finance.

What is new in our account is both less and more than initially appears to be the case. It is less insofar as management incentives in the general family of justification have been considered in the literature. Indeed, the tyranny of the markets, demanding results each quarter and smooth income trajectories, has long been bemoaned, and blamed for short-termist and other "safe" decisions such as minimizing research and development expenditures. In response to this rhetoric, the European Union has recently decided to abolish the

[2] M. Sanger-Katz, "A Fear of Lawsuits Really Does Seem to Result in Extra Medical Tests", *New York Times*, July 23, 2018, available at https://www.nytimes.com/2018/07/23/upshot/malpractice-lawsuits-medical-costs.html; A. Kachalia and M. M. Mello, "Defensive Medicine—Legally Necessary but Ethically Wrong? Inpatient Stress Testing for Chest Pain in Low-Risk Patients", 173 *JAMA Internal Medicine* 1056, 2013, doi:10.1001/jamainternmed.2013.7293.

obligation for listed companies to report financial results every quarter; the U.S. is considering following suit.[3] Consider the rationale often given when companies go private: that they need time that the market will not give them to make costly but ultimately value-enhancing changes. Michael Dell took Dell private a few years ago, giving precisely this rationale.[4] Indeed, corporate law has long been concerned with managers' ability and incentive to entrench themselves, and a body of Delaware corporate law, notably the *Unocal* doctrine, has arisen that nominally invokes judicial greater scrutiny when management entrenchment is a particular concern.[5] This concern is part of a broader story in the literature, including in our account, in which shortcomings in corporate performance are attributed to managerial agency costs.

[3]See the Directive EU 2013/50 of 23 October 2013. See also R. C. Pozen and M. Roe, "Keep Quarterly Reporting", *Brookings*, September 5, 2018, https://www.brookings.edu/opinions/keep-quarterly-reporting/. Interestingly, the implementation of the EU Directive in the UK does not seem to have produced the desired effects. Very few companies abandoned quarterly reporting and those that did it lost analyst coverage. Moreover, there seems to be no association between the frequency of reporting and investment in capital assets and R&D. See R. C. Pozen, S. Nallareddy, and S. Rajgopal, "Impact of Reporting Frequency on UK Public Companies", 3 *CFA Institute Research Foundation Briefs*, March 2017, available at https://www.cfainstitute.org/en/research/foundation/2017/impact-of-reporting-frequency-on-uk-public-companies.

[4]"The Rationale for a Private Dell", presentation to investors by Dell CEO Michael S. Dell, June 2013, available at https://epsnews.com/wp-content/uploads/2013/06/The-Rationale-for-a-Private-Dell.pdf. Interestingly, five years after going private, Dell has announced that it will be going public. A. Rosen, "Dell Is Going Public Again", *Boston Globe*, July 2, 2018, available at https://www.bostonglobe.com/business/2018/07/02/dell-going-public-again/ITzK26NxQeOR0VLUqhb9RP/story.html. An obvious cost at issue when companies go private is that public shareholders cannot share in the value creation. This is a common observation; a recent article in a business publication describes some recent examples. G. Colvin, "Take This Market and Shove It", *Fortune*, May 17, 2016, available at http://fortune.com/going-private/.

[5]Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del., 1985); see also C. A. Hill, B. J. M. Quinn, and S. Davidoff Solomon, *Mergers and Acquisitions: Law, Theory, and Practice* (West Academic, 2016), 473–475, 478–479. Indeed, the reigning rationale for golden parachutes, provisions that pay management upon a change in control, is to counter the effects of their excess concern for their own jobs so as to make them be better agents, agreeing to a deal if it is in the best interests of their principal, the corporation (and its shareholders).

But our account does three novel things. First, we demonstrate that the anticipated need to justify is far more important than has previously been recognized. The need to justify is pervasive, and the people who may anticipate the need to justify their decisions include not just managers, but also their investors, who themselves may need to justify their results to their clients or beneficiaries. Moreover, what might count as a justification (beyond the obvious, immediate good results) has not been sufficiently well articulated.

Our account identifies a type of agency cost, "justification costs." Justification costs are costs resulting from decisions insofar as and to the extent that they are motivated by justification. The intuition is, again, captured by the examples above. But for the doctor's need to justify herself, she would not have ordered nearly as many expensive tests. Stated differently, under conditions of uncertainty, justification costs are higher. By contrast, in conditions of less uncertainty, the most justifiable decision is apt to be the decision made without regard to justification. Justification costs are agency costs because they are incurred to benefit the agent at the expense of the principal. They may also be social costs, harming the greater society.

Second, to our knowledge, the relationship between these sorts of agency costs and more traditional agency costs, such as those involving self-dealing or empire building, has not been considered. Reducing traditional agency costs typically means increasing accountability and the consequent anticipated need for justification; by contrast, reducing costs of justification generally means increasing managerial leeway, which might increase traditional agency costs.

Third, and most importantly, we introduce a role for uncertainty. Under conditions of low(er) uncertainty, more accountability does not necessarily increase justification costs, which are apt to be low in any event, and does reduce traditional agency costs. But under conditions of uncertainty, accountability increases justification costs, potentially in an amount greater than any reduction in traditional agency costs; under some circumstances, reducing accountability, thereby granting managers more leeway, may be preferable.

We propose a solution to the problem posed by justification costs in the corporate governance context – a mechanism by which managers and stockholders can agree on granting managers some leeway for a specified period of time, in the form of "Control-Enhancing Mechanisms" (CEMs). A CEM might, or might not, condition continuing leeway during the period on management's meeting certain agreed-upon conditions. We consider how our argument as to the existence of justification costs might apply in some private and public financial contexts, and suggest some solutions in those contexts as well.

1.1 Overview of the Argument

Our main focus is corporate governance. The paradigmatic reason, in theory, to constrain managers is that managers have the ability and incentive to benefit themselves at the expense of the firm and its shareholders. Unconstrained managers may seek to take advantage.

What sorts of managerial benefits are at issue? Traditional examples include a CEO and board who rebuff an acquirer so they can keep their jobs, or a CEO having his company make acquisitions as much or more so he can lead a larger company, with the associated compensation and prestige, as for the benefits to his company. We refer to the costs associated with managers' ability and incentive to pursue these benefits as "traditional" agency costs.

To constrain managers, why not just give the shareholders more power? As mentioned above, the power tends to be exercised by shareholder activists, a subset of shareholders whose interests, it is argued, may differ from those of all the shareholders, and of the corporation – and differ in a particular way: they may want the company to borrow an enormous amount or sell large portions of its business to pay out large dividends or make stock repurchases, without regard to whether doing so undermines the company's longer-term prospects. (Shareholder activists are arguably the successors to corporate raiders who, in attempting to acquire control of a company as cheaply as possible, may have been willing to threaten to freeze out the remaining shareholders at a low price, or who might talk shareholders into voting for something that would be less favorable to the corporation than what the managers were proposing). Indeed, the specter of shareholder activist engagement may make company managers pre-emptively adopt short-termist or other strategies that are harmful to the company, the broader society, or both.

This is, of course, a highly contentious characterization. Managers might suffer from long-termism, postponing the realization of under-performance for want of better times that will never come.[6] And the shareholder activists, ostensibly as principals, acting for themselves, would (and do) say that they have a good idea as to how the company should be run, one that is superior to the incumbent management's idea.[7]

Of course, ex ante, it's not clear whether the management's idea, the activist's idea, or some other idea, is best. We would go even further, arguing that the characterization of shareholder activists as being short-termist makes the concept seem far more determinate and intelligible than it is. First, there is no way to define short-termism objectively in a world in which the optimal allocation of capital to future projects is uncertain.[8] Second, the need for managers to justify under uncertainty creates a bias towards short-term performance. Third, this bias could be detrimental in contexts of high uncertainty, where it would be efficient for managers to be entrepreneurial, but the need to justify to shareholders prevent them from being such. While we take no position on whether short-termism is or not desirable, for we believe the answer depends on the particular company, we note that the claim that activist shareholders lead to short termism is both underspecified and unproven – as is the opposite claim that activist shareholders are not responsible for short-termism.

Managers and many shareholders (including activist investors as well as institutional investors generally) are and/or believe themselves to be accountable to others, who are themselves often accountable to others and/or believe themselves to be. They may be called to account if there is a bad outcome, even though the process they followed was

[6] A. M. Pacces, "Exit, Voice and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance", 9 *Erasmus Law Review* 199, 2016, at 207.

[7] Indeed, the activist's idea may reflect an agency or agency-like cost: activists, too, need to justify their decisions and performance to their sources of funding.

[8] For this reason, one of us has characterized shareholder activism as a "conflict of entrepreneurship". See Pacces, "Exit, Voice and Loyalty", supra note 6, at 207–211.

thorough and otherwise appropriate, and untainted with self-interest. Or they may be called to account if there has not been a good outcome quickly enough. They therefore make their decisions with an eye towards future justification – of bad outcomes, or of outcomes that are not good quickly enough. Again, this holds true for the managers, the activists, and for institutional investors.

A manager making a decision for its justifiability may be imposing an agency cost to the extent that the outcome departs from what would be best for the principal, the corporation and its shareholders or, in the case of a money manager, the client.[9] Additionally, whether or not the decision-maker is an agent, a decision made for its justifiability may yield social costs. There is some, but not complete, overlap between the two types of costs. An obvious example is acceding to short-termist pressures and cutting back on a research and development project that might have led to significant monetary benefits to the company and significant health benefits to the broader society.[10] Institutional investors may be imposing an agency cost insofar as their choices – with regard to investing and voting – generate lower returns than would be the case if they were not making decisions with justification in mind. And money manager herding in the years leading up to the financial crisis, motivated in significant part by concerns of justifiability, yielded an agency cost, as the managers' clients' returns suffered from the managers' purchase of overpriced low-quality securities, as well as an enormous social cost.

[9] M. C. Jensen and W. H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 3 *Journal of Financial Economics* 305, 308–310, 1976.

[10] Calling these "costs" is in a sense artificial – they suggest an implicit baseline relative to which the non-existence of a drug is worse, when there is no reason why the baseline 'should' include the existence of the drug. Wherever the baseline is, or even if no baseline can in principle be specified, the amounts at issue are appropriately considered costs. That is, the costs are either costs the society should not have to incur, such as the cost of pollution relative to pristine air, or foregone benefits, such as more money spent on drug development. For our purposes, we will simply call some set of consequences to the society from a move to short-term focused actions (research and development not pursued, radical reductions in immediate and short-term costs) or more "justifiable" actions "costs" even though we cannot specify a principled baseline. Hill discusses this point further in C. A. Hill, "The Rhetoric of Negative Externalities," 39 *Seattle University Law Review* 517, 2016.

What sorts of strategies would be most readily justified? The obvious candidates are following a well-worn path, doing less,[11] and doing something with a quick payoff. These may be perfectly sensible strategies. But they are problematic when they don't represent the best assessment of how to proceed. When is that the case? This is where uncertainty comes in. By uncertainty, we mean Knightian uncertainty, a characterization of the future which does not yield a measurable prediction. Uncertainty is to be distinguished from risk, which is quantifiable and technically can be described by widely accepted probability distributions.[12] Uncertainty makes justification more difficult; accountability puts justification more in the forefront, as those who are accountable envision the greater difficulties of justifying their decisions made under uncertainty.[13] There are no established methods that can, ex ante, yield a sufficiently determinate prediction or sufficiently useful probability distribution; bad outcomes cannot be justified by reference to established methods. The problem of not being able to predict the future is of course pervasive. But with risk, there are conventional, and thus readily justifiable, ways to proceed – conventional strategies, in both the colloquial and technical uses of that term. A conventional strategy largely assumes that the future will look like the past, and gives considerable credence to majority opinions.[14]

[11] Consider in this regard the familiar finding that acts of omission are far less harshly judged than acts of commission. See, *e.g.* M. Spranca, E. Minsk, and J. Baron, "Omission and Commission in Judgment and Choice", 27 *Journal of Experimental Social Psychology* 76, 1991.

[12] Frank Knight, *Risk, Uncertainty and Profit* (Houghton Mifflin, 1921), 19–20. "The practical difference is that in [risk] the distribution of the outcome in a group of instances is known (either through calculation a priori or from statistics of past experience), while in the case of uncertainty this is not true, the reason being in general that it is impossible to form a group of instances, because the situation dealt with is in a high degree unique." Ibid. at 233.

[13] The higher the uncertainty ex ante, the higher the hindsight bias ex post. See G. M. Gulati, J. J. Rachlinski, and D. C. Langevoort, "Fraud by Hindsight", 98 *Northwestern University Law Review* 773, 2004. In the absence of a conventional risk assessment justifying the decision at the outset, courts, peers, and investors may be more apt to infer misjudgment from a negative outcome. See also H. Spamann, "Monetary Liability for Breach of the Duty of Care?", 8 *Journal of Legal Analysis* 337, 2016.

[14] According to Keynes, our judgments about the future, of which we know very little, are made conventionally. "In practice we have tacitly agreed, as a rule, to fall

The more uncertainty there is, the more the most readily justifiable strategy may diverge from the decisions that the decision-maker thinks are best and would make but for the potential need for justification.[15] A company, and the society, might be better off if the company pursued its manager's best ideas, not her most-readily-justified ideas; both investors, and the society, might have been better off if money managers had not just followed the herd and had made their own assessments of investment quality.

That corporate actors are accountable and thus act with the need for justification in mind has some good effects. As we discuss, it helps address and minimize traditional agency costs. What a manager might do that would yield such a cost is familiar; the manager's knowledge that she will be asked to demonstrate that she is, for instance, not empire-building or hiring an unqualified relative, might serve as a constraint

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back on what is, in truth, a convention. The essence of this convention – though it does not, of course, work out quite so simply – lies in assuming that the existing state of affairs will continue indefinitely, except in so far as we have specific reasons to expect a change." J. M. Keynes, *General Theory of Employment, Interest and Money* (1936), 152 (Ch. 12, IV).

[15]Keynes later clarified that deciding conventionally includes, among other things, relying on the judgment of the majority of people:

> How do we manage in such circumstances to behave in a manner which saves our faces as rational, economic men? We have devised for the purpose a variety of techniques, of which much the most important are the three following:
>
> (1) We assume that the present is a much more serviceable guide to the future than a candid examination of past experience would show it to have been hitherto. In other words we largely ignore the prospect of future changes about the actual character of which we know nothing.
>
> (2) We assume that the *existing* state of opinion as expressed in prices and the character of existing output is based on a *correct* summing up of future prospects, so that we can accept it as such unless and until something new and relevant comes into the picture.
>
> (3) Knowing that our own individual judgment is worthless, we endeavor to fall back on the judgment of the rest of the world which is perhaps better informed. That is, we endeavor to conform with the behavior of the majority or the average. The psychology of a society of individuals each of whom is endeavoring to copy the others leads to what we may strictly term a *conventional* judgment. J. M. Keynes, "The General Theory of Employment", 51 *Quarterly Journal of Economics* 212, 1937, at 214 (emphases in the original).

against her doing so. But the need for justification also has some potentially bad effects. For the most innovative businesses, the trajectory of how the business will proceed and evolve is notably unpredictable,[16] and the manager (and investor) will be particularly concerned with how to justify themselves should there be a bad outcome. Where the innovation is occurring at the outset of the enterprise, the managers and financiers can come together to decide on appropriate metrics for performance and the desired amount of oversight vs. leeway for the managers. But going forward, this becomes far more difficult, with perils present for excesses on both sides. In order to deal with an uncertain future, adaptation is crucial. However, the need for justification undermines adaptation of decision-making to new circumstances, encouraging as it does resort to known patterns, in effect, again, an assumption that the future will be like the past.

With this in mind, let us consider how the allocation of power between managers and those who would challenge them has been addressed in corporate law. The principal mechanisms that help management fend off activists and acquirers are early disclosure of shareholdings, staggered boards, poison pills, antitakeover laws, and, depending on how they are structured, dual-class stock and tenure voting.[17] Managers with more ability to fend off activists and acquirers have more leeway, which includes leeway to take advantage – to impose traditional agency costs. But less leeway may yield more agency costs related to justification.

How do the two types of costs compare? And how should the fact that activists themselves face justification costs be taken into account? We argue that under conditions of uncertainty, the justification costs become a bigger factor, and may exceed the reduction in traditional agency costs that less leeway can yield.

We argue for a new mechanism: through agreement with shareholders, managers of existing public companies should be able to be insulated from removal for a specified period of time, using a CEM.

[16] C. M. Christensen, *The Innovator's Dilemma* (Harvard Business School Press, 1997).

[17] Neither antitakeover laws nor pills without staggered boards are effective against activists; indeed, pills without staggered boards aren't particularly effective at all. See our discussion of this point in Chapter 3, infra.

Our mechanism would be contractual. It would be chosen by companies, agreed to by shareholders, and tailored for companies' particular circumstances. In particular, the company's management – or the controlling shareholder, if there is one – would need to persuade outside (institutional) investors that their 'big idea' warrants a period of leeway, during which they would not have to fend off shareholder activists. The leeway could be for a specified period of time; it might, too, be subject to being shortened if specified thresholds or conditions were not met. Proceeding in this way should have significant benefits over alternatives such as taking the company private, while yielding other efficiencies, such as making the prospective returns on innovation available to the investing public. We expect that this mechanism would principally be used under conditions of greater uncertainty.

We briefly discuss the role of justification in other contexts as well, including as to both private and public actors in the financial realm.[18] As to the former, we suggest a change to law that could discourage justification-motivated decision-making by money managers. As to the latter, we suggest ways to make financial policymakers more entrepreneurial in various contexts, and in particular, more responsive to changed circumstances.[19]

Our account is largely, although not exclusively, within the rational paradigm. It is within the rational paradigm insofar as it concerns self-interest that, in the case of agents, has costs to their principals, and in the case of agents and principals, has costs to the broader society, or at least, deprives the society of what would have been beneficial expenditures. It differs insofar as the rational paradigm and indeed, even behavioral work, treats 'reality' as ultimately discernible – a person

[18] One intriguing article, by Professors McDonnell and Schwarcz, suggests a role for "Regulatory Contrarians" in helping regulators consider other perspectives, including perspectives uninfluenced by justification concerns. B. McDonnell and D. Schwarcz, "Regulatory Contrarians", 89 *North Carolina Law Review* 1629, 2011. We discuss this article and this suggestion further in the text accompanying notes 317-321.

[19] For the theoretical framing of this problem in financial regulation, see H. Nabilou and A. M. Pacces, "The Law and Economics of Shadow Banking", in I. H.-Y. Chiu and I. G. MacNeil, eds., *Research Handbook on Shadow Banking: Legal and Regulatory Aspects* (Edward Elgar Publishing, 2018), https://www.elgaronline.com/view/edcoll/9781785362620/9781785362620.00008.xml.

is ‘overconfident,’ for instance, where the ‘correct’ level of confidence is known or somehow knowable.[20] Again, a critical feature of uncertainty is that the possible outcomes and associated probabilities the future presents are not necessarily knowable even within a broad range. Ex ante and even ex post, we may not know, for instance, whether a manager’s idea was ‘wrong.’[21] Circumstances may yield a bad ex post result; the result may reflect some defect in the idea, or it may not.

In sum, uncertainty in dealing with the future is pervasive, and so is the need for agents and others to justify their decisions. Our contribution in this article is to bring a consideration of justification costs and notably, justification costs under uncertainty, into the realm of corporate

[20] One of us has written extensively on this issue. See, C. A. Hill, “Beyond Mistakes: The Next Wave of Behavioural Law and Economics”, 29 *Queen’s Law Journal* 563, 2004; C. A. Hill, “A Positive Agenda for Behavioral Law and Economics”, 3 *Cognitive Critique* 85, 2011.

[21] Behavioral law and economics, in our view, has come to have two different and, to some extent conflicting, meanings. The original meaning, and one that still has considerable viability, is that behavioral law and economics concerns mistakes and altruism, thus contrasting (and disagreeing) with law and economics, which hypothesizes lack of systematic mistake-making and self-interest. This is not the sense in which we are using the term “behavioral law and economics.” Rather, we use the term as it is meant when applied to George Akerlof and some other scholars, to explore dimensions of rational behavior not typically explored in the standard economic models. Consider in this regard not only Akerlof’s recent work on identity, but even his famous lemons paper (G. A. Akerlof, “The Market for ‘Lemons’: Quality Uncertainty and the Market Mechanism”, 84 *Quarterly Journal of Economics* 488, 1970). Going further than Professor Akerlof and his co-authors, we question the dichotomy between good and bad decisions implicit in the labels rational and irrational. Uncertainty may make it impossible to know even in theory whether a decision is rational or irrational, or correct or incorrect, when it is made or for some time afterwards. Because all decisions about the future are made under uncertainty, they cannot be rational or irrational in the traditional sense. They are as rational as they can be (H. A. Simon, “A Behavioral Model of Rational Choice”, 69 *Quarterly Journal of Economics* 99, 1955) or, to put it as Keynes (*General Theory of Employment,* supra note 14, Ch. 12, IV, pp. 152-153) did, they are rational inasmuch as they rely on a convention. In the law and economics literature, Richard Posner (“Shorting Reason”, *The New Republic*, April 15, 2009) criticized Akerlof and Shiller’s behavioral account of Keynes’ notion of animal spirits. Compare Keynes, *General Theory of Employment,* supra note 14, Ch. 12, VII, pp. 161-163, with G. A. Akerlof and R. J. Shiller, *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism* (Princeton University Press, 2009).

governance analysis, focusing on when uncertainty might warrant more leeway for managers. When uncertainty is low, accountability should be higher, which would naturally lead to decision-making made more with justification in mind – that is, more conventional decision-making. But this should not yield an increase in justification costs insofar as the most justifiable decision is also the decision that would have been made had justification not been at issue. By contrast, when uncertainty is higher, decision-making leeway, or discretion, should be higher, so as to encourage non-conventional decision-making. The new mechanisms and rules we propose allow the quantum of accountability to change over the lifecycle of publicly held enterprises, as well as during market cycles to which policymakers may be pressured to react.

Our article proceeds as follows.

Chapter 2 argues that the traditional framing of corporate governance debates neglects the role of justification and in particular, justification under uncertainty, instead being undergirded by incomplete accounts of parties' interests and aptitudes and parties' views of each other's interests and aptitudes. In the canonical paradigms, managers might take advantage or have bad ideas, something that can and should be limited by appropriate incentive alignment, constraints and market discipline. Or, shareholders activists are out for themselves, not shareholders generally, and hence, their ability to force managers to listen to them should be limited. The lens of insufficiently constrained traditional self-interest on the part of managers obscures the role of justification under uncertainty – of managers as well as investors. No distinction is made between managers who would use leeway to benefit themselves and those who would use leeway to follow their best judgment. The need to justify acts as an efficient constraint on the first situation, but is inefficient in the second. Likewise, institutional investors who need to justify to the individuals or entities whose money they are ultimately investing insist that managers are accountable in their turn. But when uncertainty is high, there is more call for entrepreneurial judgment, and thus less benefit from the constraints the need for justification imposes.

In some respects, this is not so different from the standard story – managers who claim to want time to let their ideas pay off, vs. investors who are guarding against manager advantage-taking and incompetence and can't tell if the managers are telling the truth or not. And it's not as though there is a 'fact of the matter' as to advantage-taking vs. incompetence. A manager might genuinely think the comfortable way he has done things and wants to continue doing things (or, for that matter, the risky way he wants to try) is the right way. It may not be known until later, if ever, if the manager was right. What our account does is to stress the extent to which conventional reactions to uncertainty can harm firms and harm society, and suggest ways to give managers constrained leeway that could yield a better result for shareholders as well as society.[22]

In Chapter 3, we briefly explore the history and some present-day contexts in which the principal corporate governance debates are played out in the U.S. and in Europe.

Our summary of the history and context includes discussions of the background legal regime (as to the U.S., notably the Section 13(d) regime and antitakeover laws), but we focus mainly on mechanisms such as staggered boards, poison pills, dual-class shares, and tenure voting/loyalty shares. Most of the discussion concerns the U.S., where some of the mechanisms are more widely employed and ruled on by courts, but European practices and legislation are discussed as well, particularly with regard to dual-class and loyalty shares. Our main point is that these mechanisms all assume that the corporate governance problem to be addressed is how to balance the need for managerial leeway (what one might call a "less accountability" regime) with the need for more accountability to guard against managers' incentive and ability to take advantage in traditional ways, without taking into account the role justification costs should play.

[22]Indeed, even readers not persuaded that justification is an important motivation might favor our solution so long as they are persuaded that short-termism is a problem that markets are not on track to correct. See C. A. Hill and B. McDonnell, "Short and Long Term Investors (and Other Stakeholders Too): Must (and Do) Their Interests Conflict?", in C. A. Hill and S. Davidoff Solomon, eds., *Research Handbook on Mergers and Acquisitions* (Edward Elgar Publishing, 2016), 396-415.

Chapter 4 sets forth and defends our proposal for giving managers leeway for a limited period of time under certain circumstances, contrasting it with other mechanisms discussed in Chapter 3. We argue that managers should be able to negotiate with the corporation's shareholders (or minority shareholders, if the managers are the corporation's controlling shareholders) for the issuance of dual-class shares which would give managers (and controlling shareholders owning less than a majority of the shares) control of the corporation for a specified period of time under certain circumstances.

Chapter 5 discusses additional applications of our framework in other spheres in private and public finance.

Chapter 6 concludes.