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Relational Investing and Agency Theory

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RELATIONAL INVESTING AND AGENCY THEORY

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INTRODUCTION

This Article analyzes how, and when, corporate governance could be improved by utilizing “relational investing.” The term relational investing is just coming into vogue and there does not yet seem to be a consensus on what it means. Although the term has been trumpeted on the cover of *Business Week*,¹ before the Conference on Relational Investing at Columbia University,² relatively little legal writing had been published on the subject.³

For the purposes of this Article, we define relational investing to encompass commitments to buy and hold significant blocks of a corporation’s stock.⁴ And it is particularly important that the relational

¹ Judith H. Dobrzynski, *Relationship Investing: A New Shareholder is Emerging—Patient and Involved*, BUS. WK., Mar. 15, 1993, at 68.

² Conference on Relational Investing, Institutional Investor Project of the Center for Law and Economic Studies, Columbia University School of Law, New York, N.Y. (May 6-7, 1993).

³ For an example of one of the few articles on the subject, see Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871 (1993). Lilli Gordon and John Pound recently completed an empirical analysis of the related concept “active investing.” Lilli A. Gordon & John Pound, *Active Investing in the U.S. Equity Market: Past Performance and Future Prospects* 8 (1993) (unpublished manuscript, Gordon Group, Inc., Newton Mass.).

⁴ Alternative definitions are possible. Gordon and Pound, for example, distinguish among active investors using a number of factors, including: whether the investment was hostile or friendly, whether the investor is a catalyst or a monitor, and whether the investor seeks board representation. Gordon & Pound, *supra* note 3, at 9-10. In this Article, we distinguish both between hostile (non-negotiated) and friendly (negotiated) investment and between proactive and reactive monitors, but do not address many subtler details that may ultimately determine whether the monitoring will be effective.

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investors commit not to tender their shares to hostile bidders.⁵ Using our definition, relational investing is used to foreclose or reduce hostile takeover threats, replacing this form of external discipline with enhanced internal discipline by the relational investors. The long-term investment induces the relational shareholders to invest more in acquiring information about the effectiveness of management. To be effective internal monitors, however, relational investors must be able to use this information to influence corporate policy. At a minimum, relational investors must be “provocable”—they must be able to increase the likelihood that poor management or poor policies will be changed. Relational investors might accomplish these changes through either internal (informal negotiation or proxy contest) or external (tender offer) means.

Although we will often assume that relational investors are committed to patient oversight, it is important to remember that these commitments are usually noncontractual, suggesting that an implicit commitment to buy and hold stock must be self-enforcing. This self-enforcement constraint might be especially useful in determining when relational investing is likely to arise. For example, the short-term illiquidity of large blocks of stock might make the buy and hold commitment more credible. Moreover, large block holders often will lack an incentive to reduce the size of their holdings. The 13(d) filing requirements of the Securities Exchange Act⁶ could also facilitate relational investing, because unfulfilled representations to buy and hold stock can give rise to legal liability. Using the minimalist definition that relational investors commit not to tender a large block of shares, it is possible that relational investing could reduce agency costs by providing a more effective form of corporate governance. This is far different from arguing that, as an empirical matter, relational investing is superior to more traditional forms of corporate governance. Indeed, some theorists suggest that with “friendly” relational investing, there is a substantial risk of entrenched managers and exacerbated agency costs.⁷ Without adjudicating the ultimate efficacy of relational investing, our analysis illuminates how relational investing might create value and highlights the contexts in which it is most likely to be effective.

We generate three main conclusions from our analysis of relational investing: First, relational investing can reduce agency costs, both by increasing the principal’s incentive to acquire information, and by improving the principal’s ability to foster a monitoring reputation through a long-term relationship with the firm’s management. Large block holders have a greater incentive to monitor than do “rationally ignorant” atomistic shareholders. In addition, the commitment to hold for long periods of time permits relational investors to enter more credibly into self-enforcing implicit contracts that discipline poor managerial decisions and abilities.

Second, relational investing may be better suited to mitigating “moral hazard”⁸ problems than traditional types of monitoring. In particular, potential third-party bidders are less likely to respond to problems of moral hazard than to problems of adverse selection. Even in a strong form efficient capital market, external monitors may not have an adequate incentive to discipline managers who have succumbed to moral hazard and caused the corporation to bear an inefficient sunk cost. Relational investors, in contrast, have a multiperiod incentive to respond.

Third, relational investing can be rationalized by either of the following theories: (1) the threat that managers will lose their jobs is minimal; or (2) managers face too great a threat of losing their jobs. Distinguishing between excessive and inadequate discipline leads us to predict that negotiated and non-negotiated relationships are likely to occur in different settings. Hostile (non-negotiated) relational investments are likely to produce larger gains when managers face too little pressure from internal or external markets. Friendly (negotiated) relational investments produce larger gains when managers face too much pressure from external markets to take inefficient actions.⁹ But friendly investments are also more likely to displace valuable external discipline and lead to a reduction in shareholder value. Hence, it is possible that non-negotiated investments would produce more uniformly positive results, while negotiated investments may be consistent with value creation or entrenchment.

This Article is divided into three sections. The first section distinguishes between two different types of “governance failure,” which we characterize as distortions and deficiencies in managerial discipline. This section then explores the possibility that poor managers face too low a probability of firing and that good managers face too high a probability of firing. The second section provides a preliminary framework to analyze: (1) why managers may be subject to too much or too little discipline;

⁵ As discussed *infra* text following note 5 and accompanying note 6, investors—if provoked by predetermined manifestations of poor management—might initiate a search for an external bidder to replace incumbent management.

⁶ Securities Exchange Act of 1934 § 13(d), 15 U.S.C. §§ 78m, 78p (1988).

⁷ See *infra* text following note 16; see also Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987 (1994).

⁸ See *infra* note 33.

⁹ Because the gains from non-negotiated deals are greatest when internal and external discipline has been deficient, hostile investments are likely to occur when managers have been undermonitored. Similarly, because the gains from negotiated deals are greatest when external discipline has distorted managerial incentives, friendly investments occur more often.

and (2) whether relational investing can mitigate each type of disciplinary error. In the last section, we explore the characteristics of a market which would make relational investing more likely to add value. This section includes a cursory analysis of two settings where relational investing has already flourished: venture capital investments and certain leveraged buyouts (“LBOs”).

I. DISTORTIONS AND DEFICIENCIES IN MANAGERIAL DISCIPLINE

A widely accepted goal of corporate governance is to economize on agency costs.¹⁰ Proponents of relational investing argue that, at least for some corporations, governance by relational investing is superior to alternative structures. In particular, they argue that relational investing can dominate the current model’s separation of ownership from control.¹¹

However, in considering the ills of the status quo, arguments regarding relational investing spring from two distinct types of agency costs that afflict the “Berle and Means corporation.”¹² Some argue that inflated takeover threats distort managers’ behavior. Others argue that the lack of internal oversight by boards of directors cause managers to pursue their self-interest to the corporation’s detriment.¹³

According to the “distorted discipline” school, managers fear losing their jobs following a hostile takeover. As a result, they are pressured to maximize short-term stock price to the detriment of the fundamental value of the corporation. The “deficient discipline” school argues that managers capture boards of directors and that consequently, the boards fail to monitor management behavior. Thus, we might usefully distinguish between situations where good managers might mistakenly be fired (distorted discipline), and those where bad managers might mistakenly be retained (deficient discipline). An important goal of corporate governance is to efficiently reduce both of these types of error.¹⁴

A. *Relational Investing as a Response to Distortions in the Capital Market*

Our sense is that much of the impetus for relational investing comes from those who believe that takeover threats have distorted managerial incentives: managers who fail to maximize short-term profitability face the possibility of job loss after a hostile takeover because stockholders are impatient. Relational investors create value because they are more patient.

If the disciplinary distortion of the takeover market were the only concern, corporate law could respond by increasing the power of target corporations to defend against hostile takeovers. A combination of the antitakeover statutes and the *Time-Warner* “just say no” defense ought to be sufficient to insulate good managers from inefficient takeover pressure.¹⁵ However, allowing this kind of insulation from capital market discipline presumably could lead to large increases in the

other type of disciplinary error. Removing all forms of external discipline could leave managers with too little supervision.

A strong-form argument¹⁶ for relational investing is that it replaces the distorting discipline of takeover threats with an enhanced threat of relational oversight. Relational investing might thus mitigate the failures of the external market (distorted discipline) and the failures of the internal market (deficient discipline) by decreasing the threat of external monitoring, while credibly increasing the threat of internal monitoring.

Even if relational investing does not reduce the threat of external takeover, the semi-strong form argument holds that it may still add value by enhancing the internal oversight of the board of directors. But as stressed above, it is unlikely that merely reducing the external threat, without increasing internal monitoring, would be sufficient to add value. In fact, given this scenario, there is a substantial possibility that relational investing would amount to little more than the white squire defensive strategy of parking stock with an investor who is captured by managerial interests.

¹⁰ See, e.g., OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 298325 (1985).

¹¹ Given the nascent status of relational investment theory, one has more freedom to ascribe a wide range of possible beliefs to its nebulous set of proponents. This is especially true after *Business Week* proposed concatenation of Bernard Black, Joseph Grundfest, Louis Lowenstein, Michael Jensen, Michael Porter, and Lester Thurow. See Dobrzynski, *supra* note 1, at 69.

¹² The term “Berle and Means corporation” describes a corporate governance structure in which ownership and control often reside in separate persons. This structure has become the hallmark of American industry. See ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 10 (1933); Gilson & Roe, *supra* note 3, at 873, 876.

¹³ See, e.g., Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 *YALEJ.* 13, 14-15 (1985) (comparing “agency-cost” and “shareholder-welfare” hypotheses).

¹⁴ See WILLIAMSON, *supra* note 10, at 298-325.

¹⁵ See *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989).

¹⁶ The efficient capital market hypothesis asserts that observed securities prices should always reflect the available information in the market, thus foreclosing the possibility of all but ephemeral arbitrage opportunities. It comes in one of three forms, each reflecting varying definitions of “available.” The “weak” form of the hypothesis states that only *historical* information about a security is embodied in its price. The “semi-strong” form asserts that *all public* information about the security factors into its price. The “strong” form states that *even nonpublic* information is reflected. See, e.g., Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 *J. FIN.* 383 (1970).

B. *Negotiated vs. Non-Negotiated Relational Investing*

The distinction between distorted and deficient discipline also leads to predictions about when relational investments will be negotiated (friendly) and when they will be non-negotiated (hostile). Value-enhancing relational investments are more likely to result from friendly negotiations with management when the takeover market is inefficiently distorting managerial incentives. Conversely, non-negotiated relational investments are more likely to result when there is too little managerial discipline.

However, not all instances of negotiated relational investments will enhance shareholder value. Negotiated relational investments that reduce the threat of external tender offers could entrench managers by selling equity to captured investors.¹⁷ It is even more difficult to evaluate whether friendly relational investing is of the entrenching or the monitoring sort, because short-term stock price behavior is a particularly weak test of friendly relational investing. When relational investing results from a belief that the capital market may improperly price managerial decisions, it is inappropriate to look at short-term stock price reaction to a relational strategy as a measure of this belief's accuracy. Instead of an event study, one would need to undertake the much more labor-intensive task of analyzing the underlying long-term performance or long-term stock price reactions (although interpreting this data is fraught with difficulties of its own).

It is therefore not surprising that Gordon and Pound find few gains from negotiated relational investing,¹⁸ both because relational investment can be used for entrenching, as well as monitoring ends, and because even value-enhancing investments might not be reflected quickly in the firm's stock price. Neither of these problems is as prevalent with hostile (non-negotiated) relational investments. Hence, theory suggests, and Gordon and Pound have found, significant excess stock returns are associated with hostile relational investments.¹⁹

II. RELATIONAL RESPONSES TO DISCIPLINARY FAILURE

The previous section distinguishes between two broad types of disciplinary failure that might subject management to imbalanced oversight. Academics have focused, for the most part, on deficient monitoring as the primary principal-agent problem. In contrast, proponents of relational investing seem to be more concerned with the distorting disciplinary incentives of takeovers. The principal-agent literature illuminates the difficulty that principals (shareholders or the board of directors) may have in attaining reliable information about managerial behavior.²⁰ Given managers' important informational advantage, the best incentive scheme may be to allow managers to pursue self-interested goals to the detriment of company welfare.²¹

These different theories about agency costs generate different predictions about the need for relational investing and the appropriate form that it should take. For example, Gordon and Pound distinguish between relational investors who are "catalysts" and those who are "monitors."²² Prior beliefs about the type of disciplinary failure will determine which category of investment is appropriate. Catalyst investments are particularly appropriate if the company's management has had deficient internal and external discipline. Monitoring investments, however, are more appropriate if there is a threat that the capital market will distort the incentives of good management. For example, the success of Warren Buffet, a well-known relational investor, seems to be as a monitor, not as a catalyst, because he tends to invest in companies with good management, not bad. His *modus operandi* is especially successful when management needs shelter from the vagaries of an unconstrained takeover market.

¹⁷ It is also possible that non-negotiated (hostile) relational investments might be caused by the same distorting influences that determine the stock price and thus, whether a firm is subject to takeover threats. See, e.g., *infra* section II.B.2. Accordingly, we cannot confidently assert that even hostile relational investments are value-enhancing—although the current empiricism of Gordon and Pound, along with the structural willingness of the hostile relational investor to commit to long-term positions supports our hypothesis. Gordon & Pound, *supra* note 3, at 1929.

¹⁸ For example, they find that non-negotiated voting initiatives to change corporate policy without seeking control have had "a consistently and dramatically positive impact on share values." Gordon & Pound, *supra* note 3, at 44. They conclude that "the value effects of friendly 'relationship investments'" are qualified in part because remarkably little has occurred to date in the United States. *Id.*

¹⁹ For example, the authors find that hostile voting initiatives to change corporate policy are associated with more than a thirty percent increase in firm value. *Id.* at 35. But see *supra* note 17 (possibility that hostile relational investments could distort managerial discipline).

²⁰ See, e.g., PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATIONS, AND MANAGEMENT* 496 (1992).

²¹ However, a simple adverse selection model with imperfect signals can generate both types of error. See *id.* at 149-54. If shareholders are only informed about a crude proxy for managerial ability which may be affected by other, unrelated factors (profits, for example), then in equilibrium, shareholders may at times fire non-shirking managers and at other times, fail to fire shirking managers. For example, exogenous and unobservable bad news could drive down the profits for non-shirking managers and, consequently, lead to their dismissal. Similarly, unobservable good news could mask the shirking of bad managers, insulating them from discharge.

²² Catalyst investors seek an immediate change of a poor policy, whereas monitors "seek to invest in companies as long-term investors supportive of the company's chosen strategic direction." Gordon & Pound, *supra* note 3, at 14.

This section attempts to do two things. First, we list the causes of deficient and distorted discipline. Second, we evaluate whether different forms of relational investing might mitigate these failures. In a sense, all agency costs could be attributed to failures of internal (directors/shareholders) or external (capital market/takeover) disciplinary mechanisms.²³ Nonetheless, we have emphasized the dichotomy between deficient and distorted discipline because so much of the impetus for relational investing comes from those who criticize the disciplinary threat of takeovers. Although deficient discipline can have internal as well as external causes, most theories about disciplinary distortions are theories about failure of the external capital market.²⁴

Our thesis is that relational investors can reduce agency costs in four ways: (1) because of their large stake in the company, relational investors have incentives to gather information and monitor management; (2) because of their commitment to hold shares for an extended period, relational investors can facilitate long-term incentive schemes that require the presence of an enduring principal; (3) because of their large stake in the company, relational investors can facilitate value-enhancing takeovers by taking actions to induce bids and by mitigating the Grossman and Hart free-rider problem;²⁵ and (4) because of their commitment to hold shares for an extended period, relational investors can insulate corporations from inefficient takeover attempts.

First, consider a shareholder's incentive to gather information and monitor management. Management oversight is a public good. Individual investors are too small to have an incentive to monitor management. The gains from monitoring grow in proportion to a shareholder's stake in the firm, but the costs of monitoring do not. Hence, an investor with a larger stake in the firm will gather more information.

To illustrate, suppose the relational investor spends resources to identify a value-increasing improvement relative to the plans of current management. Let P be the probability of finding an improvement. Let $c(P)$ be the cost to the relational investor of identifying an improvement with probability (P). It is natural to assume that more must be spent to get a higher probability of finding an improvement, $c' > 0$, and that additional increases in the probability of identifying an improvement are more costly, $c'' > 0$. Once an improvement is found, it is implemented at the relational investor's suggestion, creating a value (V). A relational investor owning a fraction (\mathbf{a}) of shares gets a gain $\mathbf{a}V$ as a result of the improvement. In deciding how much to spend, the relational investor will choose P to maximize the net gain $P\mathbf{a}V - c(P)$. The optimal P is found by equating marginal cost and marginal benefit: $c'(P) = \mathbf{a}V$. Since $c'' > 0$, the larger the share (\mathbf{a}), the greater the relational investor's expenditures in monitoring. There still will be underinvestment in information gathering and monitoring (since $\mathbf{a} < 1$), but the free-rider problem is lessened to the extent that the relational investor's share is large.

Second, monitoring management is an ongoing process. Managers make decisions over time; information about performance is similarly acquired. If the managers and owners have complete knowledge of their preferences and the environment, then an explicit contract covering all contingencies can be written. However, in a world with unforeseen contingencies or where it is difficult for courts to verify information, implicit contracts may be preferred.²⁶ To implement some types of implicit contracts it may be necessary to have an enduring principal. A relational investor, committed to hold shares for a long time, can provide the continuity necessary to carry out the terms of an implicit contract that makes managerial rewards or punishments depend upon observed performance measures, and actually is needed to collect information on performance and to execute the incentive scheme. Even if performance is observed without costs, the relational investor may still be needed to make the implicit contract self-enforcing; the relational investor can create a reputation for upholding the terms of the implicit contract. Thus, relational investors have an incentive to discipline certain types of known managerial failures (particularly moral hazard problems) in situations where third-party bidders would not take corrective action.

Third, relational investors can increase the probability of value-enhancing bids in two ways. Relational investors have greater incentives before a bid (ex ante) to search for value-enhancing bidders, as well as greater incentives to subsidize some of the costs of a takeover. After a bid (ex post), relational investors have less of an incentive to free-ride on value-enhancing bids. In essence, if shareholders believe that a bid will succeed without their participation, they have an incentive not to tender so that they can reap the full benefits of new management. Large relational investors, on the other hand, are more

²³ Managers might also be disciplined by labor and product market competition. See Bengt R. Holmström & Jean Tirole, *The Theory of the Firm*, in 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 61, 94-97 (Richard Schmalensee & Robert D. Willig eds., 1989).

²⁴ However, boards of directors might internalize these distortions and discipline those managers who deviate.

²⁵ Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980).

²⁶ Explicit contracts may not offer sufficient flexibility in the face of unforeseen events; if courts cannot verify the occurrence of such events, then explicit contracts cannot be made contingent on them.

likely to realize that their failure to tender will reduce the likelihood of a takeover's success, and consequently, they will be more likely to tender.

Finally, while the prior three effects respond to disciplinary deficiencies, relational investing can also affect disciplinary distortions. By placing large blocks of stock in the possession of shareholders trusted by both management and the market, relational investing can reduce the distorting threat of inefficient takeovers. Managers trust that the relational investor will reject takeover bids that are not driven by fundamental analysis.²⁷ The market trusts that the internal investor is providing enhanced internal discipline so that takeovers are unlikely to increase firm value. This theory suggests a testable hypothesis: firms owned by national investors like Berkshire Hathaway are less likely than other firms to be subject to takeover offers. As stressed earlier,²⁸ this reduced threat of takeover by itself is unlikely to provide a sufficient rationale for relational investing, because managers can reduce the threat of takeovers by other means. Displacing external discipline, without also enhancing internal discipline, is unlikely to enhance managerial performance.

These last two rationales illustrate the practical difficulty in identifying the effects of relational investing. Given that the third and fourth rationales posit that relational investors might facilitate takeovers and impede takeovers, respectively, it becomes easy to see how different camps can claim that relational investing can accomplish all things. Whether relational investors should facilitate or foreclose tender offers depends on one's theories about whether takeovers create or destroy value. It is possible, however, that any individual firm might be subject to tender offers based both on fundamental and nonfundamental considerations. If both types of takeovers exist, large shareholders have incentives to differentiate between them in deciding whether to support or block a particular bid. A key difficulty for researchers is trying to divine what the implicit contract that the relational investors have with a particular firm entails, to evaluate observationally whether the investors are abiding by the agreement, and to determine whether the implicit agreement enhances corporate governance.²⁹

A. *Deficient Discipline*

Managers may have freedom to neglect the corporation's interest because the board fails to monitor their conduct (and take appropriate action) or because the capital market fails to discipline through various takeover mechanisms. In this section, we explore why internal and external discipline might be deficient and why relational investing might produce enhanced managerial monitoring.

1. *Enhancing Internal Discipline*

The internal monitoring of managers can fail to provide adequate oversight for several related reasons. Diffuse ownership of stock gives individual shareholders little incentive to collect information about managerial performance. Shareholders might consequently be rationally apathetic³⁰ and might passively vote for the reelection of incumbent management.³¹

Moreover, the board of directors may not adequately police the conduct of corporate officers. Managers may capture the board of directors, since officers often control the selection of the board. Consequently, board members may have a conflict of interest in reviewing the performance of the people who in this sense are their employers. This well-known conflict has led to calls for creating a more independent board structure.³²

Yet, even an independent board may have difficulty developing an incentive scheme that produces efficient managers. As the principal in a principal-agent relationship with managers, the board of directors encounters both problems of "moral hazard" and "adverse selection."³³ The possibility of moral hazard stems from the agent's "hidden action." The board can only imperfectly observe an agent's efforts, making it difficult to reward and punish agents appropriately. Adverse selection, on the other hand, stems

²⁷ See *infra* section II.B.2 for a discussion of stock price distortions that might induce tender offers even when management is maximizing the fundamental value (more specifically, underlying cash flows) of the firm.

²⁸ See *supra* text accompanying notes 14-15.

²⁹ For example, if relational investors tender their shares to a third party, are they breaching the commitment to be patient, or are they fulfilling their obligation to tender to third parties who will enhance the firm's fundamental value? Alternatively, if the investors refuse to tender their shares, are they entrenching incumbent management, or are they fulfilling their obligation to reject takeovers which distort managerial incentives?

³⁰ See FRANK H. EASTERNBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); Robert C. Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776, 779-83 (1979).

³¹ Joseph Grundfest has questioned, however, whether ignorance should necessarily lead toward passive acquiescence as opposed to passive abstention. Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 909 (1993).

³² See, e.g., Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

³³ Moral hazard is the contracting problem that arises when the actions of one of the contracting parties are unobservable. Adverse selection is the problem that arises when an attribute of one of the contracting parties is unobservable.

from the agent's "hidden information." Because the board can only imperfectly observe an agent's innate ability, it is difficult to hire and retain only managers with high ability.³⁴

Both moral hazard and adverse selection are forms of agency costs that result from the principal's imperfect information. Based on the amount of information available, the principal can attempt to design an incentive scheme that minimizes the costs of adverse selection and moral hazard. But, the standard result reached by the principal-agent literature is that imperfectly informed principals cannot induce first-best effort or first-best ability from their managers.³⁵ The greater an agent's information advantage, the more difficult it will be for a board to design an incentive scheme to deter adverse selection and moral hazard. The agent's informational advantage, then, is a leading cause of deficient discipline.

Relational investing has the potential of reducing managers' informational advantage. As discussed above, relational investors who have committed to holding large blocks of stock have greater incentives to collect information about both the managers' innate abilities and efforts. Instead of basing managerial incentives on crude measures of performance, such as quarterly profits, that are influenced by unobservable exogenous factors, such as an economic recession, relational investors can condition their support of management on less noisy signals of managerial performance. The relational investors may acquire information which allows them to ascertain with greater confidence whether managers are unskilled or shirking.³⁶

The incentives of relational investors to acquire more detailed information could, for example, allow them to base managerial incentives on the performance of other corporations in the industry.³⁷ This possibility also suggests that a corporation's suppliers or customers might be especially well-placed to act as relational investors—they begin with more detailed knowledge of at least one aspect of the firm.³⁸

The main point is that relational investors, by acquiring more information, can reduce the agency costs of both adverse selection and moral hazard. The distinction between these two principal-agent problems will take on increasing importance as we turn now to failures in external (capital market) discipline, because relational investors may be able to discipline moral hazard when potential third parties would not.

2. *Enhancing External Discipline*

The capital market provides an important discipline to management. However, third-party bidders may be deterred from displacing inefficient managers for at least three reasons: ex post free-riding, insufficient ex ante inducements, and failure to discipline moral hazard. We argue that relational investors may be able to mitigate each of these takeover impediments and thereby facilitate external discipline.

a. *Ex Post Free-Riding*

If a firm's assets would be more valuable under different management, then a raider should be able to acquire control by offering incumbent shareholders a premium price for their shares, and then installing value-enhancing management.³⁹ Grossman and Hart, however, point out a fallacy in this reasoning: if the ownership of shares is diffuse, then there is a free-rider problem⁴⁰—small shareholders will only tender if they are paid the post-takeover value of the firm. Suppose the firm's value increases to v under the new management, and the raider makes a contingent tender offer of x for one-half of the firm's shares. Where $x < v$, a small shareholder, thinking it will not be the pivotal shareholder, will not tender, because by retaining the shares the shareholder can receive the full v . Hence, the raider must offer $x = v$ to assure tender. But, with all the surplus going to the shareholders, the raider has no incentive either to search for desirable targets or to incur any takeover costs. The Grossman and Hart model illustrates how the shareholders' ability to free-ride on the efforts of the raider can destroy the incentives for value-enhancing takeovers.

An excellent recent article by Holmström and Nalebuff establishes, however, that the crux of the free-rider argument is based on the assumption that shareholders are small and blocks of shares are

³⁴ Alternatively, it is difficult to compensate managers according to their innate ability.

³⁵ DREW FUDENBERG & JEAN TIROLE, *GAME THEORY* 48, 243-318 (1992); JEAN-JACQUES LAFFONT, *THE ECONOMICS OF UNCERTAINTY AND INFORMATION* 146-48, 153-79 (John P. Bonin & Helene Bonin trans., 1989).

³⁶ See Bengt Holmström, *Moral Hazard and Observability*, 10 *BELL J. ECON.* 74 (1979); Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 *BELL J. ECON.* 55 (1979) (both articles showing how more informative data improves incentives for managerial performance).

³⁷ Andrei Shleifer, *A Theory of Yardstick Competition*, 16 *RAND J. ECON.* 319 (1985).

³⁸ This point is inspired by Ron Gilson and Mark Roe's insightful thesis about *keiretsu*. Gilson and Roe emphasize that industrial cross-ownership facilitates global contractual governance, not just additional managerial monitoring. Gilson & Roe, *supra* note 3, at 882-88.

³⁹ See *infra* text accompanying notes 87-89 (discussing the possibility that bidders have incentives to make inefficient—or value-decreasing—bids).

⁴⁰ See Grossman & Hart, *supra* note 25, at 43.

indivisible, so that tendering their small lots is an all-or-nothing proposition for the shareholders. They show that the raider may garner a significant fraction of the surplus if we relax this assumption and allow shareholders to tender a fraction of their total shares.⁴¹

This can be seen in the equilibrium of a simple takeover game. Suppose the raider makes a contingent tender offer for one-half of the shares at the current share price (p). Each shareholder tenders one-half of his or her shares, receiving no profit on the shares tendered, but making a gain of $v - p$ on the remaining shares. In equilibrium, no shareholder has an incentive to tender less than one-half of his or her shares, because doing so prevents the takeover and the share price remains at p . The raider's offer deters free-riding because each shareholder becomes a pivotal player whose failure to tender destroys the opportunity to gain any takeover premium.

This equilibrium relies on the standard Nash assumption that equilibrium strategies are common knowledge.⁴² Each player must understand that defecting from the equilibrium strategy of tendering half his or her shares will cause the tender offer to fail.⁴³ But it will be particularly difficult to establish these beliefs amongst all the shareholders; there are a variety of stable ways that the bidder and shareholders could split the gains from takeovers, and it is unclear how the parties coordinate on any particular split.

In the equilibrium example where the bidder tenders for one-half of the shares at price (p),⁴⁴ the takeover surplus is divided equally between the raider and existing shareholders. But the raider can capture a higher fraction of the surplus if the raider is permitted to tender an offer below the current share price. This strategy might be called a "reverse two-tier" offer—the front bid is substantially less than the back-end value. Unlike the back-end freeze-out,⁴⁵ however, a contingent offer for one-half of the stock at a value below the current share price is not a transaction that gives rise to appraisal rights.⁴⁶ Hence, it seems such offers would not be legally prohibited. To induce tender, the raider can offer any $x < p$, such that the loss on the tendered shares $p - x$ is no more than the gain on the untendered shares $v - p$. In this way, the raider can capture an arbitrarily large share of the surplus and avoid the free-rider problem.

Grossman and Hart and Holmström and Nalebuff thus announce two extremely divergent equilibria. Grossman and Hart suggest that free-riding will impede any takeover bid below the post-takeover value of the shares. Holmström and Nalebuff's analysis of shareholders who might tender a fraction of their shares considers the possibility that bidders could retain all the gains from the acquisition. Empirically, the vast majority of these gains seem to go to the target shareholder,⁴⁷ which casts doubt on the Holmström and Nalebuff approach as a panacea to the free-rider problem.

But, a situation in which the Holmström and Nalebuff mechanism is likely to be particularly effective at mitigating the free-riding problem is when relational investors have purchased large blocks of stocks. Shareholders are more likely to free-ride when their failure to tender is not going to block the merger. Holmström and Nalebuff explain why small shareholders are more psychologically-inclined to free-ride:

The explanation comes from a declining marginal incentive to tender. Tendering provides two benefits: one is the direct payment of [the bid price]; the second is the increased chance of success. The second benefit is more highly valued, the more shares that are held. As the number of shares held diminishes, the increased chance of success is worth less and less. Once all shares are tendered, the former shareholder no longer cares about the outcome. The hardest share to motivate an individual to tender is his last one. This helps explain why the case where everyone has only one share minimizes the raider's surplus.⁴⁸

⁴¹ Bengt Holmström & Barry Nalebuff, *To the Raider Goes the Surplus? A Reexamination of the Free-Rider Problem*, 1 J. ECON. & MGMT. STRATEGY 37 (1992).

⁴² FUDENBERG & TIROLE, *supra* note 35, at 11-13.

⁴³ Moreover, it assumes that no shareholders "irrationally" refuse to tender. If the proportion of irrational shareholders is common knowledge, a raider could adjust the offer to gain control, despite non-tender by this irrational group.

In many contexts, free-riding is not deterred by giving multiple owners independent veto power. For example, in the standard takings setting, an individual landowner may rationally refuse to accept the market price when the city offers to buy an entire block (to build, for example, a new sports stadium). But in the real estate setting, the landowner is holding out to bargain for a higher price. In the takeover setting, the ability of the tender offeror to make the purchase *contingent* on receiving control of the company prevents an individual shareholder from exploiting the bargaining power that is conferred by sequential purchase.

⁴⁴ See *supra* text following note 40 and accompanying notes 41 and 42.

⁴⁵ A freeze-out merger is often the back end of a two-tier takeover process. In the front end, the acquiring firm pays a premium for a majority of the target corporation's stock. Once in control, the acquiring firm (and the newly-controlled target board) force the back-end freeze-out merger upon the remaining minority shareholders of the target company. See Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1937-38 (1991).

⁴⁶ DEL. CODE ANN. tit. 8, § 262 (1991 & Supp. 1992); REVISED MODEL BUSINESS CORP. ACT § 13.02 (1984).

⁴⁷ Gregg A. Jarrell et al., *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49 (1988). Moreover, we do not observe tender offers below the share price, as suggested by the more extreme "reverse two-tiered" strategy.

⁴⁸ Holmström & Nalebuff, *supra* note 41, at 50.

Larger relational investors are less likely to free-ride for the simple reason that their failure to tender is likely to preempt the bidder's success: large shareholders are often pivotal voters. As ownership becomes more concentrated, there is a greater chance that individual large shareholders will be pivotal or "but for" causes of the success or failure of the takeover. As owners of large blocks of shares, relational investors reduce the ex post free-rider problem, and therefore, increase the ex ante incentives of third parties to provide external discipline.

b. Insufficient Ex Ante Inducements

Shleifer and Vishny present an alternative explanation as to how large relational shareholders could facilitate external discipline.⁴⁹ Their analysis eliminates the free-riding barrier to takeovers because they assume that the bidder's tender offer equals the post-takeover value of the shares.⁵⁰ Hence, the raider's gains are realized on the block of shares it owns before the takeover.⁵¹ This outcome seems to be more consistent with the statistical studies⁵² than with the extreme version of the Holmström and Nalebuff model.

Large relational investors have a heightened incentive to expend resources toward inducing value-enhancing bids. These expenditures can take a number of forms, including bearing some of the takeover's transaction costs or the sale of some of their shares to potential bidders at a discount.⁵³ The incentive to incur these costs stems from the gain relational investors would realize on their block of shares.⁵⁴

The Shleifer and Vishny model suggests that the share price of a firm increases with a larger relational investor because the stock market anticipates that the relational investor's greater incentive to search for value-enhancing bids will increase the likelihood of a takeover. The expected takeover premium, however, is smaller with a larger relational investor, both because the pre-bid stock price reflects a higher probability of takeover, and because third parties are willing to mount takeovers for a wider range of potential improvements (including smaller managerial improvements). Despite the smaller premium, relational investing increases shareholder welfare because the probability of takeovers is increased.

Takeovers are not the only means for a relational investor to affect corporate policy. A relational investor can also bring about change through informal negotiations which may be much less costly than a takeover.⁵⁵ Indeed, Gordon and Pound provide evidence that this type of relational investing, which does not seek to gain outright control, results in significant positive returns relative to the market.⁵⁶

The option of informal negotiation may also affect how the market interprets a decision to mount a takeover. For example, we might assume that the negotiation process is less costly, but that it only secures a fraction of the potential gains of a takeover because incumbent managers have more discretion in a negotiation to resist the implementation of changes than if there is a takeover. The relational investor will tend to use informal negotiation in situations where there is a smaller potential increase in value and resort to takeovers in more extreme situations. Negotiation avoids large, fixed takeover costs, yet still reaps a significant fraction of the gain from change. When the potential increase in value is sufficiently large, however, the relational investor will prefer to incur the higher fixed takeover costs in order to fully realize the increase in value.⁵⁷ Hence, informal negotiation signals to the small shareholders that a smaller potential improvement has been discovered by the relational investor. Likewise, a takeover bid signals a large improvement, enabling small shareholders to demand a larger takeover premium than they would if

⁴⁹ Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986).

⁵⁰ Target shareholders have no incentive to free-ride if they can receive the post-takeover share value by tendering.

⁵¹ The Williams Act allows the bidder to buy at least five percent through open market transactions before announcing its intentions. See securities Exchange Act of 1934 § 14(d)(1), 15 U.S.C. §§ 78l(i), 78m(d-e), 78n(d-f) (1988). The ability to buy a large block is also regulated by the Hart-Scott-Rodino Antitrust Improvements Act of 1976, which requires a firm considering mergers to notify the Justice Department. Pub. L. No. 94-435, § 201, so Stat. 1383 (1976) (codified at 15 U.S.C. § 15 (1988)). These notifications quickly become public and may further reduce the bidder's ability to secretly accumulate shares.

⁵² See e.g., Jarrell et al., *supra* note 47, at 50-58.

⁵³ Haddock, Macey, and McChesney suggest a number of informational investments of targets that are consistent with the Shleifer and Vishny theory. David D. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987).

⁵⁴ There are incentives to incur these costs with the relational investor's share of the firm. However, there are still too few takeovers, because the relational investor is only gaining from its own shares.

⁵⁵ See Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984).

⁵⁶ See Gordon & Pound, *supra* note 3, at 36-38.

⁵⁷ More formally, suppose the benefit of the takeover is b and that the cost of the takeover is c . As an alternative to facilitating a takeover, the relational investor (owning share (a) of the firm) can use informal negotiation to achieve a fraction (b) of the total takeover benefit (b) at a fraction (g) of the takeover cost (c) . Informal negotiation will be preferred by the relational investor to facilitating a takeover, whenever the profits from informal negotiation $(abb - gc)$ are greater than the profits from facilitating a takeover $(ab - c)$, or equivalently $(1 - g)c > a(1 - b)b$. Holding c fixed, we see that this is satisfied for small b . Hence, the relational investor will tend to use informal negotiations when the takeover gains are small and will rely on takeovers when the takeover gains are large. This sampling bias implies larger premiums will be associated with takeovers when informal negotiation is possible.

informal negotiation had taken place. As a result, a takeover premium may be larger when there are relational investors who are able to negotiate informally for change.

This signaling effect suggests that takeovers initiated by relational investors may induce a relatively large potential increase in stock price, while earlier we suggested that the increased likelihood of a merger may reduce the size of the observed premia (because the pre-bid stock price will anticipate the enhanced probability of takeover).⁵⁸ It is unclear which of these effects would dominate.⁵⁹

We have seen that by holding a large block of shares, relational investors might facilitate takeovers and external discipline. Our definition of relational investing also included a commitment to patience—that is, not tendering the shares to another buyer. In many circumstances, it may be easy for large shareholders to make this commitment because their shares are more valuable if held as a large block. This in itself will tend to prevent a relational shareholder from not breaking up the block of shares and selling to a more diffuse set of shareholders. For example, in the Shleifer and Vishny model sketched above, the value of the firm would fall if the relational investor reduced its stake. It is possible that one relational investor would want to sell the block to another single owner, who will have the same incentives for enhanced internal monitoring. Indeed, because the value of the firm increases with the size of the relational investor's stake, a commitment not to buy a larger stake is perhaps more important than a commitment not to reduce the stake.⁶⁰

The primary reason why a relational investor might be willing to break up its block ownership of shares is to purchase a more diversified portfolio. Holding a large block of shares in a single company may prevent the relational investor from fully diversifying that firm's idiosyncratic risks.⁶¹ Because the relational investor is providing a public good to the other shareholders, however, there may be an incentive for the board or other shareholders to compensate the relational investor for continuing to hold the large stake.⁶² For example, the relational investor sometimes negotiates for preferred stock. The incumbent board may be quite reluctant to subsidize the creation of enhanced internal monitoring. The occasions in which incumbent management have subsidized the creation of a relational owner have included a number of entrenching maneuvers.⁶³ Therefore, it is unsurprising to find that such friendly preferred placements have often lead to reductions in the value of common stock.⁶⁴

c. Moral Hazard Inefficiency

While the possibility of takeover can provide an important supplement to principal-agent discipline, there are some types of agency costs that third-party bidders are unable to control. In particular, most models of external takeover discipline focus solely on the problem of adverse selection: third parties learn that a firm has poor managers, take over the firm to fire the incumbent managers, and put in place more productive managers who will increase the value of the firm. This is the implicit rationale behind the formal economic models of Grossman and Hart, Holmström and Nalebuff, and Shleifer and Vishny, as well as many of the Law and Economics models of external discipline.⁶⁵

As discussed above, the principal-agent relationship needs to be structured to contend with moral hazard problems, as well as adverse selection. If a manager's incentive scheme (compensation contract) fails to eliminate the possibility of moral hazard (to shirk or otherwise act unfaithfully), then economic theory suggests that any "rational manager" will succumb. Replacing a manager who succumbs to moral

⁵⁸ See *supra* text following note 53.

⁵⁹ Intuitively, relational investors will tend to increase takeover premia to the extent informal negotiation is effective (*b* large) and the relational investor is ineffective at reducing takeover costs.

⁶⁰ Small shareholders will demand more for their shares if they anticipate that the relational investor will acquire a larger stake than originally announced. DeMarzo and Bizer analyze this trading problem in the case where the large stockholder cannot commit to acquiring a fixed stake. Peter M. DeMarzo & David S. Bizer, *Sequential Trade* (1993) (unpublished working paper, Northwestern University, on file with Peter Cramton, University of Maryland). The relational investor will continue to acquire shares until there is no further gain from additional purchases and the small shareholders will correctly anticipate this level of purchase. DeMarzo and Bizer show that equilibrium shareholdings without commitment are sensitive to the relational investor's initial stake. *Id.* at 24. In general, there will be a value to commitment, since commitment offers more flexibility in trading off the gains to a larger stake with the loss from reduced diversification.

⁶¹ The possibility of undiversified risk will turn on whether the relational investor's total portfolio is large enough to invest in a sufficient number of other companies. See RONALD GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 125 (1986). Several "relational investing" mutual funds have recently emerged to avoid this diversification problem by creating a pool of capital to purchase significant relational blocks of shares. The mutual fund strategy avoids the diversification problem, though only by building in an additional level of agency—as the mutual fund investors have to watch their relational investing agents. Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 *UCLA L. REV.* 811 (1992). These funds have experienced significant difficulty raising capital.

⁶² See Gilson & Roe, *supra* note 3.

⁶³ See Rock, *supra* note 7.

⁶⁴ See Gordon & Pound, *supra* note 3, at 37.

⁶⁵ See EASTERBROOK & FISCHER, *supra* note 30, at 172-73; Gilson & Kraakman, *supra* note 32, at 879-92. *But see* Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 *STAN L. REV.* 819 (1981) (discussing bad behavior as a signal of bad managers).

hazard should not by itself change the equilibrium—any new manager facing the same incentive scheme will behave in the same manner.

We believe that the takeover market is more likely to mitigate problems of adverse selection than problems of moral hazard. When a corporation is inefficient because of adverse selection, the managers are innately less productive. Replacing them with more productive managers can increase a firm's value—thus making a takeover profitable. But, if a firm is inefficient because of moral hazard, then taking over the firm simply to replace management will not increase its value. In this situation, the problem is not the quality of the managers, but the quality of the incentive scheme which circumscribes the managers' job performance. Although the Law and Economics literature often discusses internal monitoring to deter shirking, we suggest that potential bidders are more likely to take over a firm to replace innately bad managers than to replace shirkers.

It is possible that third parties may have incentives to take over a firm to put in place a more efficient incentive scheme. This will be especially true if the third party can create greater incentives with explicit contracts. Management buyouts ("MBOs") are a good example.⁶⁶ If a better explicit contract is possible, then the bidder might profitably take over the firm, institute the superior incentive contract, and then quickly sell his or her shares. Most simply, a bidder might give managers stock options (or more concentrated ownership) to increase their incentive to maximize firm value. MBOs might be considered the quintessential moral-hazard based takeover.

However, in many contexts, reducing an incentive scheme to written form is extremely costly. Indeed, while financial carrots are sometimes put in writing, it is extremely rare for terms of dismissal to be explicitly stated.⁶⁷ Most forms of corporate governance prefer to define conditions for termination implicitly.⁶⁸ Thus, most firms fail to contract around the employment at will default.⁶⁹

Distinguishing between adverse selection and moral hazard problems significantly restricts the potential scope of external discipline. If moral hazard is an agency problem, then taking over the company and replacing the incumbent management cannot by itself improve managerial performance. The only way to mitigate moral hazard problems is to improve the incentive scheme facing the manager—and there is nothing inherent in a takeover or replacement that will accomplish this result. Thus, even if ongoing moral hazard inefficiency is known by the market and reflected in the firm's stock price, it may not be profitable for informed third parties to mount a takeover effort. This reluctance to discipline managerial moral hazard becomes all the more pronounced if potential third-party bidders cannot easily observe whether managers are shirking (more specifically, succumbing to moral hazard incentives).

Given the difficulties in identifying and solving moral hazard problems, it is not surprising that MBOs—the quintessential moral-hazard based takeovers—could not begin without the financial innovation of junk bond financing.⁷⁰ Indeed, some part of these takeovers might have been due to the underpricing of this debt, which created a temporary subsidy to correct moral hazard. But as junk bonds have disappeared, so have many of the incentives to correct moral hazard problems by takeovers.

Indeed, the reluctance of third-party bidders to correct moral hazard problems may even chill their willingness to correct problems of adverse selection. This chilling effect could be caused by the difficulty of imperfectly-informed bidders in distinguishing adverse selection from moral hazard. Paul Milgrom and John Roberts, for example, have explained how "in practice it may be quite difficult to determine which is at work."⁷¹

A radio story in the summer of 1990 reported a study on the makes and models of cars that were observed going through intersections...without stopping at the stop signs.

⁶⁶ Managers, however, would need to be compensated for the increased human capital risk. See Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807, 812, 825-27 (1987); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 601 (1984).

⁶⁷ Employment contracts may define sufficient conditions for discharge (for example, theft), but few explicitly define necessary conditions.

⁶⁸ Moreover, many imperfect incentive schemes are caused by a form of adverse selection. If a better incentive scheme could be put in place to deter moral hazard by officers and other managers, then the board's failure to implement a more efficient scheme is a form of adverse selection at the board level. This failure could be caused by the board's poor quality (adverse selection) or the board's poor incentives to monitor (moral hazard). If the failure is caused by adverse selection, then third parties might profitably take over the firm, replace the board, and establish a superior incentive scheme. However, if the failure is caused by moral hazard at the board level, then replacing the board is not likely to lead to a better incentive scheme for managers—there would be no reason for the new board to behave differently than the old.

⁶⁹ See Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 949 (1984). Many executive employment contracts do, however, compensate executives whose employment is terminated before a predetermined term. See Kenneth C. Johnsen, Note, *Golden Parachutes and the Business Judgment Rule: Toward a Proper Standard of Review*, 94 YALE L.J. 909, 909 (1985).

⁷⁰ See Deborah A. Demott, *Directors' Duties in Management Buyouts and Leveraged Recapitalizations*, 49 OHIO ST. L.J. 517, 523 (1988).

⁷¹ MILGROM & ROBERTS, *supra* note 20, at 169.

According to the story, Volvos were heavily overrepresented.... How then is this observation explained?

One possibility is that people driving Volvos feel particularly safe in this sturdy, heavily built, crash-tested car. Thus they are willing to take risks that they would not take in another, less safe car.... This is essentially a moral hazard explanation....

A second possibility is that the people who buy Volvos know that they are bad drivers.... The safety that a Volvo promises is especially attractive to people who have this private information about their driving.... This is, of course, essentially a self-selection story.⁷²

Potential bidders may have the same difficulty distinguishing whether a firm's bad performance is caused by management's innate ability (adverse selection) or shirking (moral hazard)—based upon their knowledge of observable information, such as profits. If a bidder, for example, believed that it was just as likely that poor managerial performance was caused by moral hazard as by adverse selection, then their expected gains from taking over the firm and replacing management might be reduced by half.⁷³ The inability of the external market to respond to one of the two primordial agency problems increases the possibility that heightened internal monitoring—such as that provided by relational investing—might be warranted.

It is also likely that efforts to solve adverse selection problems by replacing managers would exacerbate managerial moral hazard.⁷⁴ Often, upper-tier managers are privy to key information that is useful in controlling the moral hazard of underlings. One needs to think only of the way that students often exploit a new or substitute teacher in order to envision how replacing incumbent upper management on adverse selection grounds could lead to heightened moral hazard by lower-level employees.

Relational investors can increase internal discipline by being long-term stakeholders in the firm. As an enduring party, the relational investor is able to establish and enforce implicit contracts with management, reducing moral hazard inefficiency. This gives relational investing an important advantage over external discipline: takeover discipline is limited to value-enhancing changes, whereas a relational investor can commit to follow a particular plan because the relational investor is a repeat player. Consider a simple setting without adverse selection (all managers are the same), and where managerial effort is ex post observable, but not verifiable, so that an explicit contract cannot be written. If management shirks, there is a sunk cost inefficiency. In this case, there is no incentive for a raider to replace a shirking manager, since the new manager faces the same incentive problem. In contrast, a relational investor, as a repeat player, has an incentive to replace the shirking manager in order to provide incentives for the manager not to shirk in the future.⁷⁵

Hence, even if the capital market and relational investors observe the same information, relational investors can reduce agency costs because they are repeat players. The relational investor is more credibly provokable because a failure to act can destroy the relational investor's reputation. The capital market is in a weaker position to deter moral hazard inefficiency, even in a strong form efficient market, because shirking is viewed by the capital market as a sunk cost inefficiency, rather than an opportunity to enhance value.

Recent work on the theory of repeated games suggests that the value from implicit contracting can be substantial.⁷⁶ Implicit contracting is useful in situations where information is observed by the parties, but explicit contracts cannot be written, because it is too costly for a judge to verify the information. Implicit contracts have a further advantage in that they retain flexibility with regard to unforeseen contingencies. Implicit contracts can even approximate the gains of an explicit contract with costless verification if both the principal and the agent are long-run players and are sufficiently patient.⁷⁷ Therefore, there need not be a significant loss when explicit contracts are not possible.

The success of the implicit contract turns on the relational investor's commitment not to sell, but to remain a long-term player. Such a commitment can be credibly supported by the relational investor's reputation. Selling shares can destroy this reputational value. However, even a myopic relational investor may have no incentive to sell shares if doing so reduces the value of the firm, and hence, the share price.

An example of how relational investing might be especially well-tailored to respond to problems is Warren Buffet's influence on Salomon Brothers. In May 1990, after Buffet had taken a more active role,

⁷² *Id.*

⁷³ Of course, if after the takeover, the acquiror realizes that the problem is one of moral hazard, the acquiror could install an effective incentive scheme and provide the required monitoring. In this way, the acquiror can duplicate the role of the relational investor.

⁷⁴ We are indebted to Ron Gilson for this insight.

⁷⁵ We are assuming that the raider is not a repeat player and will not monitor management, as would the relational investor.

⁷⁶ David G. Pearce, *Repeated Games: Cooperation and Rationality*, in 1 *AADVANCES IN ECONOMIC THEORY—SIXTH WORLD CONGRESS* 132 (Jean-Jacques Laffont ed., 1992).

⁷⁷ Drew Fudenberg, David Levine, & Eric Maskin, *The Folk Theorem with Imperfect Public Information* (1989) (unpublished working paper, Massachusetts Institute of Technology, on file with Drew Fudenberg, Harvard University).

Salomon changed its tradition of paying large cash bonuses. Myron Scholes⁷⁸ designed a new plan in which a fixed percentage of the bonus was used to buy stock on the open market and then held in trust for the employee for five years. Milgrom and Roberts report: “The plan won acceptance because of the inventive effects it embodies. The explicit aims were to change the culture, to encourage a long-run perspective and cooperation, and to align the employees’ interests with one another and with those of the stockholder owners.”⁷⁹

Warren Buffet’s relational position in Salomon may have influenced the corporation’s decision to improve its employee incentive scheme. While the improvement was an attempt to foster a more relational attitude among employees, external discipline may have been able to accomplish this just as well, because the changed incentives were implemented through explicit contracts. The discrete nature of the contractual change also led to a seven to ten percent increase in Salomon’s stock price.⁸⁰ Third-party bidders also might have been enticed to initiate a takeover in order to implement this change themselves. Our argument, however, is that there are other incentive changes that can only be effectively implemented by implicit relational contracts—and discrete takeover investments will not be effective in accomplishing this end. One needs more than a bridge loan to solve moral hazard.

B. *Distorted Discipline*

Management decisions may be distorted in an inefficient way by internal or external discipline. Takeover threats or aggressive stock option plans may force managers to take actions that are not in the long-term interests of the shareholders. In this section, we explore the causes of distorted discipline and how relational investors might mitigate this problem.

1. *Inadequate Measures of Managerial Quality*

Assessing managerial performance is a difficult task. Typically, the capital market only has the current profit statement and other public disclosures with which to assess performance. These are inadequate measures of managerial quality. Nonetheless, if this is the only information available, it must be relied on to distinguish good managers from bad ones. Fearing the loss of their jobs, managers might put too much weight on how decisions influence short-term profits and other public disclosures. Management thus has a tendency to act myopically.

This emphasis on short-term performance is a common complaint of executives. Current profits are overvalued by the market relative to future profits. Hence, management will use a discount rate that is too high when making investment decisions. Good projects that reap their gains in the distant future will be ignored. Bad projects that pay back quickly will be accepted.

The difficulty is not that management is inherently short-sighted; rather, myopic behavior is a rational response to the discipline imposed by an imperfectly informed capital market.⁸¹ In this case, adverse selection, together with imperfect monitoring, creates agency costs, demonstrated by the following example. Assume that some managers are good and some are bad. Good managers have a tendency to produce higher profits than bad managers. Potential raiders search for firms in the hopes of identifying one with bad managers. Once such a firm is located, a raider can gain control, replace the bad managers, and reap a portion of the gain from installing good managers. The difficulty is that the potential raider only can observe short-term profits instead of a long-term measure of performance. Because low short-term profits signal bad managers, the raider will acquire a firm and replace the managers if profits are sufficiently low. Recognizing this takeover threat, managers (both good and bad) will avoid investments that have a higher probability of triggering a takeover.

Laffont and Tirole present an alternative model in which the value of investments is observed well after the raider has entered the market for corporate control.⁸² As in the models above, the use of defensive tactics can improve shareholder welfare. The reason, however, is different. In Laffont and Tirole’s model, the possibility of a takeover interferes with the provision of long-term incentives.⁸³ Stock options can be an effective incentive device in the absence of takeovers, but managers displaced by a takeover tend to exercise their options, thereby destroying the incentive value of the options. Hence,

⁷⁸ Myron Scholes, a finance professor at Stanford University, was on leave with the firm at this time.

⁷⁹ MILGROM & ROBERTS, *supra* note 20, at 11. Milgrom and Roberts also suggest that the plan might reduce adverse selection by applicants. (“It was also expected that this scheme would influence favorably the type of people who would be attracted to work for Salomon.”) *Id.*

⁸⁰ *Id.* at 12.

⁸¹ Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61 (1988), presents a formal model of this manager myopia problem. However, the presence of myopic behavior depends on the assumption that managers have no effective way of signaling long-term performance, such as adopting a Salomon-like incentive plan that rewards long-term performance.

⁸² Jean-Jacques Laffont & Jean Tirole, *Repeated Auctions of Incentive Contracts, Investment, and Bidding Parity with an Application to Takeovers*, 19 RAND J. ECON. 516 (1988).

⁸³ *Id.* at 531.

golden parachutes, by reducing the threat of takeover, can raise shareholder welfare by improving long-term incentives. However, if the golden parachute is set too large, it creates the opposite incentives.

2. *Capital Market Prices Assets Below Fundamental Value*

The threat of takeover activity can also distort managerial incentives if third parties have incentives to arbitrage in instances where the stock price is less than the fundamental value of the firm. Reinier Kraakman details several reasons why stock price might be less than the underlying value of the firm. Of particular interest is what he terms "the market hypothesis":

[The market hypothesis] fits less easily with standard accounts of the securities market. In this view, share prices may discount asset values for reasons endogenous to the formation of the market prices. Financial economics conventionally assumes that share prices are best estimates, given available information, of the present value of expected corporate cash flows available for distribution to shareholders.... By contrast, the market hypothesis asserts that discounts arise because share prices are sometimes very poor estimates of the expected value of corporate assets.⁸⁴

Advocates of the market hypothesis have proposed a host of theoretical explanations for this failure (including models of bubbles and noise)⁸⁵ and empirical studies (including evidence that markets overreact to news or that stock returns are mean-reverting).⁸⁶

As Kraakman and others have noticed, temporarily underpriced stock can give rise to takeover activity that might distort managerial behavior.⁸⁷ Again, as summarized by Kraakman, "[T]he chief danger may not even be that discounts generate socially wasteful takeovers.... Rather, the primary danger may be that this adjustment is itself exorbitantly costly in real terms because it forces inefficient capital rationing on firms and biases managers toward short-term projects and excessive distributions to shareholders."⁸⁸ Takeovers that have no correlation with management's ability to maximize the present value of free cash flow might thus distort the incentives of managers to act in the corporation's long-term interest. Although many economists are skeptical about market failure explanations for takeovers, it is our sense that at least some of the impetus for relational investing grows out of this view.⁸⁹

3. *Opportunistic Redistribution of Rents*

Takeovers that simply seek to redistribute value can also distort managerial incentives. A number of authors have argued that third-party bidders might profitably bid to opportunistically breach implicit contracts that the target corporation has with other stakeholders.⁹⁰

The possibility of this takeover motivation restricts the set of implicit managerial incentive schemes that are still credibly self-enforcing. It may even motivate managers to breach implicit contracts with other stakeholders, such as bondholders, to reduce the threat of losing their jobs following a takeover.

4. *Insulating Managers from Distorted Discipline*

Relational investments can reduce the threat of inefficient or redistributive takeovers and thereby reduce the distorting influences of these takeovers on target management. The presence of a significant

⁸⁴ Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 898 (1988).

⁸⁵ See Fischer Black, *Noise*, 41 J. FIN. 529 (1986); Olivier J. Blanchard & Mark W. Watson, *Bubbles, Rational Expectations and Financial Markets*, in *CRISES IN THE ECONOMIC AND FINANCIAL STRUCTURE* 295 (Paul Wachtel ed., 1982); Robert J. Shiller, *Fashions, Fads, and Bubbles in Financial Markets*, in *KNIGHTS, RAIDERS, AND TARGETS* 56 (John C. Coffee, Jr. et al. eds., 1988); Andrei Shleifer & Robert W. Vishny, *Value Maximization and the Acquisition Process*, 2 J. ECON. PERSP. 7 (1988).

⁸⁶ Werner F.M. De Bondt & Richard H. Thaler, *Further Evidence on Investor Overreaction and Stock Market Seasonality*, 42 J. FIN. 557 (1987); J. Bradford De Long et al., *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703 (1990); Robert J. Shiller, *Do Stock Prices Move Too Much to Be Justified by Subsequent Changes in Dividends?*, 71 AM. ECON. REV. 421 (1981).

⁸⁷ See Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 250 (1983); Martin Shubik, *Corporate Control, Efficient Markets, and the Public Good*, in *KNIGHTS, RAIDERS, AND TARGETS* 31 (John C. Coffee, Jr. et al. eds., 1988).

⁸⁸ Kraakman, *supra* note 84, at 936-37.

⁸⁹ For a discussion of these issues from a proponent of relational investing, see Lowenstein, *supra* note 87.

⁹⁰ See, e.g., John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 7-8 (1986); Peter F. Drucker, *Corporate Takeovers—What Is to Be Done?*, 82 PUB. INTEREST 3 (1986); Charles R. Knoeber, *Golden Parachutes, Shark Repellents, and Hostile Tender Offers*, 76 AM. ECON. REV. 155 (1986); Warren A. Law, *A Corporation Is More Than Its Stock*, HARV. BUS. REV., May-June 1986, at 80, 83; Louis Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 731 (1985); Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in *CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES* 33 (Alan J. Auerbach ed., 1988).

Shleifer later concluded, however, that there was little empirical evidence of the claim that stakeholders lose from takeovers. See Sanjai Bhagat et al., *Hostile Takeovers in the 1980s: The Return to Corporate Specialization*, in *BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS* 1, 32 (Martin N. Baily & Clifford Winston eds., 1990).

block of shares owned by shareholders who are committed to resist takeovers initiated for the reasons listed in this section could thus insulate managers from the distortions of the external market.

Even shareholders who own substantially less than half of the outstanding equity might be able to reduce the threat of an inefficient takeover. This is because substantial but minority shareholders who fail to tender their shares still lessen the number of additional shares that target management needs to persuade not to tender in order to block a takeover. The ability to block takeover attempts also may be caused by the reputation of the relational investor. For example, it is commonly thought that firms part-owned by Warren Buffet are—other things being equal—less likely to be made the target of a tender offer, and that this explains why Berkshire Hathaway’s investments in Salomon Brothers and other companies were made on such favorable terms.

Although some relational investment advocacy seems to be motivated by the possibility that relational investments might reduce distorting external discipline, substantial problems in committing the large shareholders to respond efficiently to takeover offers still exist. A relational investor might face incentives that undermine this strategy by tendering too often or not often enough. Relational investors might have incentives to tender their shares to third parties that bid higher than the current market price. The relational investors’ implicit commitment not to tender their shares to redistributive takeover bids, for example, must be self-enforcing. The costs of accepting such bids must be higher than the investors’ short-term benefit. For example, if the relational investor has made implicit commitments to more than one corporation, then cashing in on one redistributive tender offer may reduce the credibility of similar commitments in other corporate investments. This is an example of how reputations can resolve the “chain-store paradox.”⁹¹ Again, Warren Buffet’s (and Berkshire Hathaway’s) substantial investment in a number of companies may increase the credibility of his commitment not to take opportunistic money and run.

The more serious problem is that relational investors will accept too few tender offers. As discussed above, we have a substantial fear that relational investing will not be used merely to “insulate” managers from the capriciousness of the external market, but will be used to “entrench” incumbent managers to act capriciously. Although relational investors are supposed to provide oversight, if the investors are captured by the managerial interests (possibly because of crossholdings or the conflicting nature of pension fund investment), then relational investing may just be a code word for a new type of entrenchment.

III. WHEN IS RELATIONAL INVESTING MOST LIKELY TO BE SUCCESSFUL?

In the previous sections we argued that relational investing can help in reducing agency costs. We now explore the circumstances under which the net gains to relational investing are likely to be largest. It is in these settings that we expect relational investing to flourish. However, our discussion is highly speculative. At this stage of research, we are unable to make firm statements about where we should see relational investing. Typically, there are offsetting factors and it is unclear which of these factors will dominate.

A. Rationales for Relational Investing

The success of relational investing in particular contexts rests on the extent to which the relational investor reduces agency costs. The reduction of agency costs can come from four sources: (1) collecting better information about managerial ability and value-enhancing changes; (2) monitoring managerial effort and implementing incentive schemes and implicit contracts; (3) introducing improvements through informal negotiation or takeovers; and (4) insulating good managers from inefficient takeover pressures.

All of these sources of gain are enhanced when ownership is diffuse prior to the relational investor’s arrival. In firms with existing large-block shareholders that are independent of management, the large shareholders essentially provide the benefits of a relational investor. An additional relational investor is unlikely to add much value. In firms where management owns a substantial block of stock, a relational investor is apt to have more difficulty influencing management decisions and hence, will be of less value. Relational investing is more likely to succeed where diffuse ownership exists.

First, the technology for information production is critical in determining the net value of relational investing. How much effort must the relational investor expend to get good information about managerial ability and effort? How difficult is it for the relational investor to identify value-enhancing changes in management strategy? Relational investors with industry and management expertise will have an advantage in information production. Situations where information is quite costly need not be necessarily

⁹¹ David M. Kreps & Robert Wilson, *Reputation and Imperfect Information*, 27 J. ECON. THEORY 253, 253 (1982); Paul Milgrom & John Roberts, *Predation, Reputation, and Entry Deterrence*, 27 J. ECON. THEORY 280 (1982). Even if the relational investor is only engaged in a single firm, the act of breaching this implicit commitment may reduce the value of all of the corporation’s implicit commitments and therefore chill the bidder’s valuation of the firm.

bad for the relational investor, so long as the reduction in agency costs is substantial. This would be the case if the conflict of interest between management and the shareholders was great and if, without the information, management had substantial ability to divert resources to itself. Thus, the better the board, the smaller is the value of relational investing.

Relational investors also create gains by monitoring and implementing incentive schemes and implicit contracts. The size of these gains depends on the magnitude of the agency problem without a relational investor. Relational investing will be more important when the likelihood of board capture is high. Board capture is more likely when the board members have been selected by the current management team. Also, the value of relational investing will increase to the extent that the interests of the shareholders and management conflict. The easier it is for management to divert resources to itself, the more important the monitoring role of the relational investor becomes.

Third, relational investors can introduce value-enhancing changes through informal negotiation or takeovers. The gains from this activity depend on the extent of the failure of external discipline. Large takeover costs and a severe free-rider problem will increase the benefit from the relational investor. Substantial gains can be reaped if the relational investor can determine when informal negotiation will be effective and when a full-scale takeover is necessary.

Finally, the relational investor insulates good managers from inefficient takeover pressures. This is most important when the takeover would disrupt long-term incentives, when the stock market is highly volatile and likely to misprice value, or when the capital market only observes poor measures of managerial ability.

To further understand the characteristics of successful relational investing, we consider how venture capital and the debt-equity decision relate to relational investing.

B. *The Venture Capitalist as a Relational Investor*

Relational investing is not entirely new. Venture capital⁹² can be thought of as an example of relational investing. The venture capitalist has a large stake in the venture and is committed to holding that stake for an extended period of time. Likewise, the venture capitalist monitors management and provides informal advice. Typically, there are detailed reporting requirements. Control resides with management, but is contingent on satisfying benchmarks. If specific goals are not met, the venture capitalist takes control.

Relational investing is similar, except that the contingent control does not appear in an explicit contract. There is good reason for this distinction. With relational investing, control is made contingent by the takeover threat. With venture capital, the contingencies for control must be made explicit. External discipline fails because there is no takeover threat without public shares. Internal discipline is also likely to be difficult without an active venture capitalist. Careful and informed monitoring is needed because of the idiosyncratic cash flows in an innovative venture.

The venture capitalist serves to reduce agency costs, just like the relational investor. The venture capitalist is useful in situations where the agency costs otherwise would be large: external discipline is not possible or is distorting because it is uninformed, and internal discipline is ineffective without in-depth knowledge and careful monitoring. Venture capital is used in new start-ups, often involving substantial research and development. Great uncertainty and long payback periods are the norm. In this environment, the returns from monitoring are large.

By analogy, relational investing might be more common in young, innovative industries, rather than in mature industries. In mature industries, cash flow is less variable and investments are more observable. All the plants have been built a dozen times before. External discipline should be easier and should involve fewer distortions because of the industry's steady cash flow. On the other hand, adverse selection may be less important in a mature industry. Hard work, rather than genius, may be critical in a mature industry like cement manufacturing, whereas genius is perhaps the essential ingredient in an innovative high-tech computer firm.

C. *Debt vs. Equity*

Our attempts to identify when relational investing would be advantageous should not be overstated. For example, we do not have a clear idea whether relational investing is more apt to be successful in a highly leveraged firm. Some relational investor proponents might best be described by their *opposition* to anything that happened in the 1980s—not only the takeover wave but also the rise of highly leveraged

⁹² Venture capital is provided by "an investor who specializes in providing equity funding to new ventures, often also providing advice and practicing active monitoring." MILGROM & ROBERTS, *supra* note 20, at 605.

capitalizations.⁹³ These advocates would probably go on record against debt financing for individualized reasons; but we find it difficult to decide whether or not debt is conducive to relational investing.

Debt itself, as a means of financing, is in some respects less relational than equity. From the firm's point of view, equity is more "patient" capital than debt because equity does not have a contractual entitlement to the repayment of principal. At least in this respect, the difference between debt and equity is the difference between an annuity and a perpetuity. Frank Easterbrook, for example, has stressed that the recurring need to refinance debt forces managers to return to the market and to subject themselves to capital market discipline.⁹⁴ But the same market failures that might distort the takeover market might also distort the debt refinancing market. Nonfundamental distortions in the capital market's valuation of the firm's assets could affect both the managers' investment and finance decisions. Therefore, if the takeover threat can be neutralized by antitakeover statutes or poison pills, then debt might be seen as the less relational form of investment.

On the other hand, leverage financing reduces the outstanding dollar value of equity and may be necessary to give relational investors the opportunity to purchase a substantial percentage of equity. The active and ongoing monitoring of Kohlberg, Kravis, Roberts & Co. and other LBO associations form a brand of relational investment that stands in sharp contrast to Berkshire Hathaway's approach. Moreover, the LBO commitment to a long-term relationship is all the more credible, because often the LBO takes the company private for five to eight years.⁹⁵

If the term "relational investment" becomes too amorphously defined, it will lose its predictive content. The fact that we see forms of relational investing both with and without significant debt is yet another indication that no one form of corporate government is likely to conform to the technological and individual characteristics of our diverse markets.

CONCLUSION

In this Article, we have identified possible advantages of relational investment as a form of corporate governance. We do not believe that relational investing is called for in all corporate forms, or that it will create value everywhere. It is difficult to say much more with confidence because the choice among different types of corporate governance is necessarily an empirical question. Theoretical predictions are also imprecise because relational investing means different things to different people including both friendly and hostile, both proactive and reactive monitoring, and both leveraged and unleveraged transactions.

Nevertheless, we have tried to identify different ways that relational investing could reduce the costs of deficient or distorted managerial discipline. Our major conclusions are that:

1. By gathering more information, relational investors can enhance the internal discipline of management.
2. By mitigating ex post free-riding and by inducing ex ante search, relational investors can facilitate value-enhancing takeovers or negotiate changes in corporate operations.
3. By committing to hold their shares for repeated periods, relational investors can enhance managerial incentives by credibly promising to respond to moral hazard problems.
4. By resisting potential inefficient takeovers, relational investors could insulate management from the capriciousness of the capital market.

Unfortunately, relational investing might have costs that are not associated with other types of corporate governance. We are particularly concerned that relational investors might resist value-enhancing takeovers, that commitments to buy and hold also force the relational investor to bear potential costs of illiquidity and nondiversification.

We have tried very tentatively to identify when the potential benefits outweigh these costs. A Stiglerian belief in survivorship would simply ask what forms of governance tend to emerge and survive in the market.⁹⁶ We are somewhat ambivalent about this approach without better information about the potential barriers to active investing.⁹⁷ However, we are also skeptical of those who suggest that relational investing is not currently a dominant form of corporate governance simply because no one had thought of it before. In between these extremes there may be some role for both academic and practitioner jawboning—Columbia's conference on Relational Investing may even serve as a bully pulpit.

⁹³ See e.g. Lowenstein, *supra* note 90.

⁹⁴ See Frank H. Easterbrook, *High-Yield Debt As an Incentive Device*, 11 INT'L REV. L. & ECON. 183 (1991).

⁹⁵ See Steven N. Kaplan, *The Staying Power of Leveraged Buyouts*, 29 J. FIN. ECON. 287 (1991).

⁹⁶ See GEORGE J. STIGLER, *THE ORGANIZATION OF INDUSTRY* 62 (1968).

⁹⁷ But the folks at Columbia have been engaging this issue with great effect. See, e.g., Black, *supra* note 85; Coffee, *supra* note 90; Gilson & Roe, *supra* note 3.

By taking an agency perspective, we have been able to illuminate the possibility of too much, as well as too little, managerial discipline. We have argued that hostile, proactive forms of relational investing are more likely to take place when there is too little discipline, and that friendly reactive forms are most likely when there is too much (distorted) discipline. An agency perspective has also led us to suggest the provocative thesis that: (1) third-party bidders may have fewer incentives to respond to managerial moral hazard than to adverse selection; and (2) as a corollary, relational investing may be better suited to respond to moral hazard by implementing improved implicit incentive schemes with repeated reputational commitments.

However, the agency perspective has difficulty illuminating the possible importance of relational voice. Most of our analysis has turned on the ability of relational investors to affect the probability of corporate control. For example, even the enhanced internal discipline and negotiation exerted by relational investors is premised on the investors' ability to facilitate management's replacement if provoked. It is of particular importance to more formally model board representation since board members have better access to information (such as the company's books) and possibly an enhanced ability to persuade.