Taxing Control

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I. INTRODUCTION

Academics and activists advocate for corporate governance reforms designed to increase the value of publicly traded firms by making managers more accountable to shareholders.¹ After years of struggle, they are finally having some success. Publicly traded firms are eliminating staggered boards of directors,² providing shareholders with a

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². Re-Jin Guo et al., Undoing the Powerful Anti-Takeover Force of Staggered Boards, 14 J. CORP. FIN. 274, 278 fig.1 (2008) (presenting data on the increasing number of firms that chose to de-stagger their boards between 1987 and 2004); see also Steven M. Davidoff, The Case Against Staggered Boards, N.Y. TIMES DEALBOOK (Mar. 20, 2012, 12:43 PM), http://dealbook.nytimes.com/2012/03/20/the-case-against-staggered-boards (“Companies that are already public are rushing headlong to ditch their staggered boards.”).
“say on pay,” and directors are paying closer attention to shareholder desires. Yet not all of the evidence fits neatly in this trend toward “good governance.” Firms continue to adopt anti-takeover protections when they make their initial public offerings. Over 86% of firms that went public in 2012 have a staggered board of directors, and both Google and Facebook chose dual-class capital structures that allow the founders to retain voting control disproportionate to their economic stake.

The inclusion of anti-takeover protections in initial public offerings presents a puzzle. Much of the corporate governance literature suggests that anti-takeover protections are inefficient because they make it harder to remove ineffective or unfaithful management and therefore increase agency costs. But this literature also suggests that firms will adopt efficient corporate governance terms before their initial public offering because concentrated ownership reduces agency costs. Firms with better terms should command a higher price from new investors in an initial public offering, and this higher price will lead to greater wealth for the managers and investors who control the firm.

Other scholars have noted this puzzle and have offered a number of explanations. Capital market imperfections may prevent initial public offering prices from reflecting


5. Davidoff, supra note 2.


7. See infra notes 23–24 and accompanying text.

8. See infra notes 25–26 and accompanying text.

differences in corporate governance terms. Firms may choose inefficient terms due to bad legal advice or because of frictions in the market for financing prior to the initial public offering. Anti-takeover protections could be efficient after all, at least for some firms, because they correct for myopic investors or some other problem. Finally, managers may choose anti-takeover provisions to signal something about their firms. This Article advances a very different explanation, one based on the Internal Revenue Code (Tax Code).

This Article begins with a variant of one of the existing efficiency explanations for anti-takeover protections. The heart of the argument is that managers are not driven solely by a desire for material gain but derive some happiness or utility from the control they exercise over their firms. When investors removed Steve Jobs from Apple, he did not just lose a future stream of income as CEO, he lost control of “his” firm. To the extent that managers derive happiness from control, they may not choose governance terms that maximize the dollar value of the firm. However, unless there is some contracting failure, they will still choose efficient terms—terms that maximize the total value of the firm (the dollar value plus the control value).

Once we introduce taxation, the manager no longer chooses efficient terms because

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10. See Daines & Klausner, supra note 9, at 113 (discussing the possibility of “the market’s failure to price [anti-takeover provisions] fully”); Coates, supra note 9, at 1304 n.14 (questioning whether “IPO pricing is so poor that adoption of defenses does not result in a lower IPO price”).

11. Because firms that hire more experienced takeover lawyers are more likely to adopt takeover protections, Coates suggests that they are likely beneficial for the manager and that the failure to adopt defenses is the result of bad legal advice. Coates, supra note 9, at 1385–86 (“The evidence also seems compelling that defenses are privately optimal for all pre-IPO owner–managers, even if not all lawyers provide that advice. In sum, blame the lawyers.”). His observation is also consistent with the argument this Article makes if one assumes that wealthier entrepreneurs (those with a lower marginal utility of wealth) are more likely to hire elite (and expensive) law firms.

12. See Klausner, supra note 9, at 774 (“Transaction costs in negotiating takeover defenses with a company’s management and information imperfections regarding the impact of those negotiations on a private equity fund’s reputation may explain the frequency with which takeover defenses appear in the charters of companies in which funds invest.”).

13. See infra notes 35–39 and accompanying text (discussing various efficiency explanations for anti-takeover provisions).

14. Bebchuk, supra note 9, at 717 (“[A]ssuming that higher asset value is associated with higher expected benefits from rent protection, some or all founders will have an incentive to signal a high asset value by adopting antitakeover arrangement.”).

15. In recent years tax scholars have begun to write on the relationship between taxation and corporate governance. For a review of this literature, see Mihir A. Desai & Dhammika Dharmapala, Tax and Corporate Governance: An Economic Approach, in TAX AND CORPORATE GOVERNANCE 13–30 (Wolfgang Schön ed., 2008). Much of this literature focuses on the interaction between corporate agency costs and the demand for tax shelters. However, in their review of the literature, Desai and Dharmapala make a suggestion that is somewhat similar to the central claim of this Article: “One further connection between ownership patterns and taxes has yet to be fully explored. The private benefits enjoyed by controllers can take either pecuniary forms (such as through tunneling into firms . . .) or nonpecuniary ones. . . . The tax system only burdens the pecuniary forms, and so implicitly subsidizes nonpecuniary private benefits.” Id. at 23. This interesting idea warrants further exploration, but this Article’s claim is different. This Article focuses on the taxation of all pecuniary returns, including returns received by shareholders, and argues that this tax distorts the choice of governance terms in a firm’s initial public offering.

16. See infra Part IV.A (discussing the private benefits of control).

the government taxes pecuniary benefits more effectively than it taxes non-pecuniary benefits. Even if the manager can increase the total value of the firm by ceding some control, she may fail to do so as she must share some of the increase in the monetary value of the firm with the public treasury. The government could eliminate this distortion by taxing the potential value of a firm (its value with optimal governance terms) or by taxing the benefits of control. However, these may be difficult or impossible to estimate. The government could also mitigate the problem by taxing devices that allow the manager to retain control such as dual-class common stock, staggered boards, and poison pills, or by simply prohibiting devices that it finds unreasonable.

Nearly all taxes distort incentives. For example, income taxes distort a worker's choice between labor and leisure. The government could avoid this distortion if it could tax individuals on the basis of their potential income (what they could earn) instead of their actual income or if the government could impose the appropriate offsetting tax on leisure. In the real world, the government cannot observe potential income or leisure, and efforts to tax proxies for potential income or complements for leisure create their own distortions. Standard income or wealth taxes may be the best taxes that can be implemented in a world of limited information.

The existing Tax Code's focus on pecuniary returns may provide the second-best taxation of public firms. For example, if we assess taxes on anti-takeover devices used by a publicly traded firm (or if we prohibit these terms), we distort the manager's decision to sell shares to the public. In the world of the second-best, there are no easy choices. Whether the distortions that corrective measures would create exceed those created by the existing Tax Code is a difficult empirical question that is left to future research. However, even if we choose not to adopt corrective measures we should still recognize the distortion of corporate control as an additional cost of taxation.

Part II examines the choice of corporate governance terms in a world with no taxation. Part III shows that if managers receive both pecuniary and non-pecuniary rewards from their firms and if the government taxes the pecuniary rewards more heavily, then managers will choose corporate governance terms that give them an inefficiently high level of control. Part IV examines the validity of the fundamental assumptions of this argument—that managers receive non-pecuniary returns and that these returns are less heavily taxed. Part V examines the conditions under which the government should take corrective action. Part VI concludes.

18. As discussed below, the effect of taxation on the level of entrenchment is theoretically ambiguous because there are offsetting wealth and substitution effects. However, only the substitution effect matters for the purposes of evaluating the efficiency of the corporate governance terms. See infra notes 46-48 and accompanying text (describing the income and substitution effects and the substitution effects' importance for economic efficiency).
19. For a more thorough discussion of these corrective measures, see infra Part V.
22. See infra note 80 and accompanying text (discussing some proposals to mitigate these distortions).
II. The Choice of Governance Terms in a Tax-Free World

The corporate governance literature suggests that anti-takeover provisions such as dual-class common stock, poison pills, and staggered boards of directors increase agency costs by making it harder for shareholders to remove ineffective or unfaithful managers. Much of this literature, therefore, suggests that these protections (or at least the strongest protections) reduce the value of publicly traded firms, and a growing body of empirical evidence supports this claim.

Agency costs exist because managers and other controlling persons generally hold a small percentage of the stock of publicly traded firms, and thus, they do not feel the full consequences of their decisions. By contrast, before a firm makes its initial public offering, its share ownership is generally concentrated in the hands of the managers and a few others who provided early assistance. Better governance terms should make the firm more valuable and enrich the managers and concentrated investors who own the firm and have the power to choose these terms. The literature, therefore, suggests that firms will adopt efficient corporate governance terms before they make their initial public offerings. One early work claimed that "firms go public in easy-to-acquire form: no poison pill securities, no supermajority rules or staggered boards. Defensive measures are


24. See, e.g., Paul A. Gompers et al., Corporate Governance and Equity Prices, 118 Q.J. ECON. 107, 125-29 (2003) (finding that investors would have earned an abnormal return of about 8.5% per year during the 1990s if they sold firms with the weakest shareholder rights and bought firms with the strongest shareholder rights); Lucian A. Bebchuk & Alma Cohen, The Costs of Entrenched Boards, 78 J. FIN. ECON. 409, 419-26 (2005) (finding that between 1995 and 2002, firms with staggered boards of directors had lower firm values as measured by Tobin’s Q); Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Firm Valuation, 25 J. ACCT. & PUB. POL’Y 409, 429-31 (2006) (finding that firms that score poorly on a corporate governance index have lower firm values); Lucian A. Bebchuk et al., What Matters in Corporate Governance, 22 REV. FIN. STUD. 783, 800-05 (2009) (finding that firms with high levels of entrenchment had lower firm value and investors in these firms earned negative abnormal returns); Paul A. Gompers et al., Extreme Governance: An Analysis of Dual-Class Firms in the United States, 23 REV. FIN. STUD. 1051, 1084-85 (2010) (finding that firm value declines when insider voting power substantially exceeds their cash-flow rights); Martijn Cremers & Allen Ferrell, Thirty Years of Shareholder Rights and Firm Valuation 10-23 (May 2011) (unpublished manuscript), available at http://www.haas.berkeley.edu/groups/finance/WP/Cremers-Ferrell%20-%20Draft%20July%202011.pdf (estimating that the adoption of a poison pill reduces firm value by five percent).

25. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 5 (1991) ("The founders of the firm will find it profitable to establish the governance structure that is most beneficial to investors, net of the costs of maintaining the structure."); Lucian A. Bebchuk, The Debate on Contractual Freedom in Corporate Law, 89 COLUM. L. REV. 1395, 1404 (1989) ("Charter provisions will consequently tend to be the efficient, value-maximizing provisions."); Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 VA. L. REV. 757, 767 (1995) (discussing the contractarian paradigm); Jensen & Meckling, supra note 23, at 323-25 (arguing that managers will adopt efficient monitoring and bonding mechanisms before selling shares to investors).
added later, a sequence that reveals much [about the inefficiency of anti-takeover provisions]."²⁶ However, subsequent research shows that this is simply not true.

A number of studies show that firms do, in fact, adopt anti-takeover protections before they make their initial public offerings. Field and Karpoff studied firms that went public between 1988 and 1992, and found that firms averaged 1.71 takeover defenses at their initial public offering and acquired an average of just 0.19 takeover defenses subsequently.²⁷ Daines and Klausner studied firms that went public between 1994 and 1997, and found that nearly all (94.5%) authorized blank-check preferred stock (allowing a poison pill to be adopted quickly), and a great many had other protections including a classified board of directors (43.5%), limits on shareholder access to the agenda (53.8%), or action by written consent (24.5%).²⁸ The popularity of anti-takeover provisions may have increased over time. Coates found that "[t]he overall rate of defense adoption increased in the 1990s,"²⁹ and news reports suggest that firms continue to make public offerings with classified boards and dual-class common stock.³⁰

The literature offers a number of explanations for this puzzle. Some of these explanations suggest that anti-takeover provisions may be inefficient despite their presence in the market. If investors misunderstand the importance of corporate governance terms, differences in the terms will not be reflected in the initial public offering price, and controlling parties will have an incentive to include terms that entrench their control.³¹ Managers often own just a portion of the equity of a firm before its initial public offering, and they may include anti-takeover protections because the cost of these terms is shifted onto other pre-IPO investors.³² Of course, this just moves the contracting puzzle back one period; one must then ask why the pre-IPO investors did not negotiate in advance for a lack of anti-takeover protections when the manager owned all of the shares of the firm. Klausner suggests that this is due to transaction costs in the market for pre-IPO financing.³³

Other scholars suggest that some anti-takeover protections may be efficient after all, or may be efficient for at least some firms.³⁴ Anti-takeover protections may increase firm value by allowing managers to resist the demands of myopic investors who would prevent the firm from making productive long-term investments³⁵ or making implicit

²⁶. EASTERBROOK & FISCHEL, supra note 25, at 205.
²⁷. Field & Karpoff, supra note 9.
²⁸. Daines & Klausner, supra note 9, at 96.
²⁹. Coates, supra note 9.
³⁰. See supra notes 5–6 and accompanying text (providing examples of firms that adopt anti-takeover protections).
³¹. See Daines & Klausner, supra note 9, at 113 ("Perhaps governance terms are expensive for investors to price at the time of the IPO. This would allow management to get protection at low (or no) cost."); Bebchuk, supra note 9, at 740–42 (exploring the possibility that "buyers will not give weight to the nuances of takeover provisions"); Klausner, supra note 9, at 764–66 ("[T]he overall rate of defense adoption increased in the 1990s,"
³². See Field & Karpoff, supra note 9, at 1867–71 ("[M]anagers with large stockholdings are unlikely to adopt antitakeover protection because the subsequent loss in share values is personally costly to them.").
³³. Klausner, supra note 9, at 768–75 ("My hypothesis relies . . . on transaction costs of negotiation and imperfections in the development of a fund's reputation.").
³⁴. For a more thorough review of these arguments, see Coates, supra note 9, at 1327–32.
³⁵. Daines & Klausner, supra note 9, at 99–100 (labeling this the "Rational Myopia Hypothesis"); Jeremy Stein, Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior, 104 Q.J. ECON.
contracts with stakeholders such as workers. Anti-takeover protections may also allow management to bargain for a higher price from a future acquirer. If corporate law cannot effectively prevent a controlling shareholder from stealing from the firm, investors will not pay a premium for firms without anti-takeover protections because they will assume that a corporate raider will quickly seize control and loot the firm.

This Article expands on another efficiency explanation for anti-takeover protections—the ability to protect private benefits that managers and investors would include in an optimal contract. The optimal contract would include benefits that are worth more to the manager than they cost the investors to provide. Assume, for the moment, that these private benefits are non-pecuniary in nature. For example, the manager may enjoy having control over the firm’s direction either because this allows her to pursue non-pecuniary goals or because she just enjoys power. The manager may effectively purchase these benefits by accepting a lower salary or a lower price for the initial sale of shares. If investors have already received their compensation or if circumstances change, investors may have an incentive to effectively renegotiate the deal by threatening to remove the manager. If the manager is liquidity constrained, she may be

655, 668 (1989) (presenting a model in which managers make myopic investment decisions even though investors behave rationally); Jeremy Stein, Takeover Threats and Managerial Myopia, 96 J. POL. ECON. 61, 63 (1988) (presenting a model in which asymmetric information causes the threat of takeovers to induce myopic investment decisions); Lucian A. Bebchuk & Lars Stole, Do Short-Term Objectives Lead to Under- or Overinvestment in Long-Term Projects?, 48 J. FIN. 719, 726–27 (1993) (showing that asymmetric information could lead to either over- or underinvestment).


37. See, e.g., Lucian A. Bebchuk, Toward Undistorted Choice and Equal Treatment in Corporate Takeovers, 98 HARV. L. REV. 1693, 1744 (1985) (arguing that shareholders may tender their shares for a price less than their true value to avoid holding a minority stake in a firm, and that anti-takeover provisions allow management to combat this problem and extract benefits from a potential buyer); Elazar Berkovitch & Naveen Khanna, How Target Shareholders Benefit from Value-Reducing Defensive Strategies in Takeovers, 45 J. FIN. 137, 137 (1990) ("[P]roponents of defensive strategies maintain that they increase the ability of target management to extract a high price for target shares."); Harry DeAngelo & Edward M. Rice, Antitakeover Charter Amendments and Shareholder Wealth, 11 J. FIN. ECON. 329, 342 (1983) (explaining that anti-takeover provisions give bargaining power to firm management); Ronald Gilson, Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense, 35 STAN. L. REV. 51, 52 (1982) (mentioning the justifications for management to engage in defensive tactics). While an increase in the bid price may be privately optimal for the shareholders, it may not be socially optimal. The increased price may represent a transfer from bidder to target. If hostile takeovers play a valuable role in reducing agency costs, the increased bargaining power may be inefficient because it will reduce the incentive for bidders to search for targets. See Frank Easterbrook & Daniel Fischel, Takeover Bids, Defensive Tactics, and Shareholder Wealth, 36 BUS. LAW. 1733, 1743 (1981).


39. See, e.g., Jensen & Meckling, supra note 23, at 312 (noting that an optimal compensation package could include both wages and non-pecuniary benefits); Daines & Klausner, supra note 9, at 89 (noting that it may be efficient for managers to use anti-takeover provisions to protect private benefits if they are unable to bid against a hostile takeover); Hannes, supra note 9, at 281–82 (arguing anti-takeover protections can protect a manager’s non-pecuniary benefits); Bebchuk, supra note 38, at 1 (arguing that it may be efficient for a firm to adopt provisions that protect the incumbent’s control to prevent wasteful competition to secure the private benefits of control).

40. For a discussion of the validity of this assumption, see infra Part IV.
unable to prevent this from occurring unless she has anti-takeover protections.41

Slightly more formally, assume that a manager owns all of the stock of a firm and needs to sell a fixed number of shares to investors in a perfectly competitive and efficient market. The manager needs to choose some corporate governance term that will determine how much control she retains over the firm. The manager’s happiness or utility depends on two things—this control and her wealth, which in turn depends on the monetary value of the firm. Both control and wealth increase her happiness, but at a declining rate. As Mark Zuckerberg’s wealth climbs past $20 billion, an additional $100 in spending money probably does not mean as much to him as it did when he was a college student. Our assumption that the manager sells shares in an efficient and competitive market greatly simplifies the analysis because whatever terms maximize her welfare will maximize social welfare.43 We can ignore the welfare of the investors because they will always pay precisely the value of the shares to them.

If the manager did not value control, she would choose the level of control that maximized the dollar value of the firm and therefore maximized her happiness. As noted above, the level of management control (or insulation from shareholder oversight) that maximizes the dollar value of the firm is subject to debate. The optimal level of control would almost certainly not grant the manager complete immunity from shareholder oversight as this would allow too much self-dealing. On the other hand, there may be some merit to claims that anti-takeover protections allow managers to invest in firm-specific human capital, allow the firm to make long-term investments, or provide some other benefit. Fortunately, we do not need to resolve this debate for the purpose of this Article. We instead assume only that, at some point, increases in the level of manager entrenchment will begin to reduce the total dollar value of the firm. Poison pills may or may not increase the dollar value of the firm, but a dual-class or pyramid capital structure that allows the owner a negligible portion of the economic interest of the firm to maintain voting control is unlikely to do so.

If the manager values control independently of wealth, the manager will not choose governance terms that maximize the dollar value of the firm because, by assumption, these terms will restrict her control. She will, however, choose governance terms and a level of control that maximizes the total value of the firm—the dollar value plus the

41. See Daines & Klausner, supra note 9, at 107 (noting that a firm may adopt anti-takeover protections to protect the private benefits of incumbents who are liquidity-constrained).


43. This assumption may be incorrect, but prior scholars have addressed the implications of inefficient capital markets for the choice of governance terms. See supra note 31 and accompanying text.

44. See Lynn A. Stout, The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance, 152 U. PA. L. REV. 667, 681 (2003) (stating that “after the manager has expended time and effort, or acquired firm-specific human capital (knowledge, skills and contacts that are uniquely valuable to the firm and cannot be sold elsewhere), she cannot earn a return from these investments except by waiting until the venture begins to produce profits”); Bebchuk, supra note 9, at 728 (“[A]nti-takeover provisions may benefit shareholders by encouraging managers (and other employees) to make firm-specific investments in human capital.”).

45. See supra note 35 and accompanying text (stating that investors may prevent managers from making long-term investments without anti-takeover protections).
control value. More specifically, she will sacrifice control until the loss in happiness from sacrificing an additional unit of control is exactly offset by the additional happiness that she gets from the increased value of the firm caused by the additional accountability to shareholders. By assumption, the manager owns all of the stock of the firm and thus bears all of the costs and receives all of the gains from her choice of corporate governance terms. She has every incentive to choose the best or most efficient terms possible.

III. NON-PECUNIARY BENEFITS AND TAX DISTORTIONS

The central argument in this Article is an application of standard optimal tax theory. To understand this theory it helps to return to the classic example—the individual’s choice between labor and leisure.\(^4^6\) Imagine a world in which individual happiness depends on two factors—leisure and consumption financed by working (foregoing leisure). If the government had full information it would implement a system of fixed taxes and transfers based on each individual’s potential earnings (her hourly wage). This tax and transfer system would be both equitable and efficient. It would be equitable in that the government could implement a system in which everyone had the same amount of money to spend or had whatever other amount that the government believed was fair or just. It would be efficient because each individual’s tax or transfer would not vary with the amount that she actually worked. As a result, she would retain all of the income that she would earn from working an additional hour and would continue to work until the happiness she would receive from spending this money precisely equaled the loss in happiness she would suffer from giving up an additional hour in leisure. She would work until the social cost of an additional hour of work (the value of the foregone leisure) is precisely offset by the social benefit of an additional hour of work (the amount that she earns or produces in that hour).

In the real world, governments cannot observe an individual’s potential income and so they tax their citizens based on actual income. An income tax has two effects on the individual’s choice between labor and leisure. First, the tax reduces the individual’s income and therefore makes her value each dollar that she retains more highly relative to leisure. This is the income or wealth effect, and it causes the individual to work more.\(^4^7\) On the other hand, the individual gets to keep only a part of each additional dollar she earns, which will cause her to work less. This is the substitution effect. The total amount worked could rise or fall depending on which effect is larger. However, it is only the substitution effect that matters for efficiency.\(^4^8\) The problem is that the individual stops working when her cost of foregoing an additional hour of leisure is equal to her private return from working an additional hour (her take-home pay) rather than the larger social return from working (her total earnings).

\(^{46}\) See, e.g., GRUBER, supra note 20, at 625–28 (describing the classic economic theory of labor supply).

\(^{47}\) See id. at 626 (“This reduction in income will have an income effect that causes her to buy fewer of all normal goods, including leisure; the fewer hours of leisure means more hours of work.”).

\(^{48}\) The income effect is a matter of distribution. The government could also create an income effect by changing the level of lump-sum taxes. As a result, the efficiency loss from a tax depends only on the substitution effect. See id. at 620 (stating “the efficiency cost of discretionary (non-lump-sum) taxes results only from the substitution effect of taxation, not the income effect”); NEIL BRUCE, PUBLIC FINANCE AND THE AMERICAN ECONOMY 425–32 (2d ed. 2001) (discussing the income and substitution effects of an income tax and noting that the substitution effect reduces economic efficiency).
This framework is easily adapted to the corporate governance context by substituting control for leisure and firm value for labor income. Assume that the government taxes the manager’s monetary return but not the pleasure she receives from control. The tax will make the manager less wealthy, increasing the value she places on an additional dollar of wealth relative to control. This income or wealth effect will cause her to choose governance terms that increase the monetary value of the firm by reducing her control. On the other hand, the manager will receive only a portion of the increase in the monetary value of the firm created by ceding control; the rest goes to the government through higher taxes. This substitution effect will cause her to choose governance terms that allow her to be less responsive to shareholders. In theory, either the wealth effect or the substitution effect could dominate, and the tax could cause the manager to choose governance terms that lead to more or less entrenchment.

Once again, however, the wealth effect is irrelevant in assessing the efficiency of the corporate governance terms as the wealth effect is a matter of distribution. The tax will distort the manager’s choice and cause her to choose terms that cause her to retain “too much” control because she will consider only the increase in dollar value of the firm that the government allows her to keep. As a result, the social value of sacrificing an additional unit of control (the pre-tax increase in the value of the firm) will exceed the social cost of relinquishing this control (the value that the manager places on the unit of control).

The above discussion treats the choice of governance terms as the manager’s alone, but many managers are already minority shareholders when their firms make their initial public offering. Many entrepreneurs sell large equity stakes to early investors to obtain start-up capital. One might still believe that these corporations will adopt relatively efficient governance terms. First, a manager could commit to using efficient terms before selling shares to outside investors. Second, outside investors who own a majority of the firm’s shares themselves have an incentive to adopt efficient terms that cede some control to the entrepreneur or manager. The entrepreneur or manager may continue to play an indispensable role in the new firm, and investors may offer generous compensation to induce her to stay. The Tax Code may cause her to take more of this compensation in the form of increased control.

There are other complicating factors. Firms may wish to use tax shelters to hide income from the government, and managers may be able to use these same obfuscation techniques to steal from shareholders. This potential for theft may, in turn, change the optimal allocation of control between managers and shareholders. The above discussion assumed that the choice of control is continuous, but many choices are discrete. For example, the manager must decide whether to adopt a classified board of directors. More significantly, other reasons may compel a manager to adopt terms that provide her with

49. I am assuming that the shareholders do not place a value on control or at least place a lower value on control.

50. See, e.g., Klausner, supra note 9, at 763 (“Between 1987 and 1999, private equity firms funded over thirty percent of the companies that went public. By the time these companies go public, private equity funds typically own a majority of their shares.”).

51. See Desai & Dharmapala, supra note 15, at 14 (“The basic intuition for how corporate governance and taxation interact is that tax avoidance demands complexity and obfuscation to prevent detection. These characteristics, in turn, can become a shield for managerial opportunism.”).
total control of a firm (e.g., a dual-class capital structure that makes a takeover nearly impossible) so that the additional distortion created by the Tax Code has no real effect.\footnote{If there is a very large income effect, the imposition of the tax can cause the manager to choose less severe anti-takeover provisions. However, this Article focuses on the substitution effect because this is what creates the tax distortion that reduces efficiency. See supra notes 48-49 and accompanying text (explaining the difference between income and substitution effect).}

Of course, most of these same criticisms apply to other applications of optimal tax theory. Many labor decisions are discrete. For example, a law student must decide whether to pursue a career in public interest or to work for a large law firm. In addition, some individuals would pick their chosen career even if the government assessed no taxes. However, the distortions created by the Tax Code can affect the labor choices made by some workers, and they can affect the control choices made by some managers as well. In a world of taxation, we cannot conclude that anti-takeover protections are efficient merely because we observe them in the market.

**IV. EXAMINING THE FUNDAMENTAL ASSUMPTIONS**

Whether the Tax Code actually causes significant distortions in the choice of corporate governance terms is a difficult empirical question that is left to future research. This Part instead examines the plausibility of two assumptions that must be true for there to be much of an effect. Part IV.A examines the assumption that managers receive significant non-pecuniary returns from running a firm. Part IV.B examines the taxation of these non-pecuniary returns relative to the taxation of pecuniary returns.

**A. The Private Benefits of Control**

Many of the private benefits of control discussed in the corporate governance literature are pecuniary in nature.\footnote{For broad discussions of the private benefits of control, see, e.g., Lucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CALIF. L. REV. 1073, 1077 (1990) (noting that private benefits serve as a motive for managers to maintain control); John C. Coffee, Jr., *Do Norms Matter?: A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151, 2157-58 (2001) (listing benefits such as above-market salaries, insider trading, and issuing cheap shares).} For example, a manager can cause the firm to provide perks such as a corporate jet or a lavish office, hire incompetent relatives at inflated salaries, or steer contracts to family-controlled businesses. The manager may see some tax advantages to taking compensation in this manner. For example, the perks may not be taxed as income, and the manager’s relatives may have lower marginal tax rates. However, the practice of securing private pecuniary benefits, often referred to as “tunneling,”\footnote{See, e.g., Simon Johnson et al., *Tunnelling* 3 (Nat’l Bureau of Econ. Research, Working Paper No. 7523, 2000), available at http://www.nber.org/papers/w7523.pdf (defining the term “tunneling”). Most evidence suggests that tunneling is less of a concern in the United States than in other countries. See, e.g., Franco Modigliani & Enrico Perotti, *Security Versus Bank Finance: The Importance of a Proper Enforcement of Legal Rules* 13-15 (Feb. 12, 1998) (unpublished manuscript), available at http://www.feem.it/userfiles/attach/Publication/NDL1999/NDL1999-037.pdf (discussing control premiums in different countries as a measure of how much value a controlling shareholder can extract from a company).} is not the focus of this Article. Rather, this Article focuses on non-pecuniary benefits that accrue to managers from running a firm.\footnote{See infra notes 62-65 and accompanying text (discussing possible sources of these non-pecuniary private benefits).}
If one views corporate governance terms as employment terms for managers, the claim that managers may allow non-pecuniary considerations to factor into their choice of terms appears self-evident. After all, many individuals choose careers that do not maximize their wealth. John Roberts reportedly accepted a salary cut from $1 million per year to $171,800 per year when he left private practice to join the U.S. Circuit Court of Appeals for the District of Columbia, and other lawyers leave lucrative careers in private practice to take positions in academia or as public advocates. Some college graduates choose careers in teaching over more remunerative careers on Wall Street. Some athletes suspend or postpone employment for a chance to compete in obscure sports in the Olympic Games even when training can cost tens of thousands of dollars and they are unlikely to receive sponsorship or other financial rewards. A few professional athletes (e.g., Bob Feller, Pat Tillman, and Ted Williams) have suspended or left lucrative careers to volunteer for military service with its low pay. While these choices are clearly not wealth maximizing, they are consistent with the maximization of utility or happiness. The lower-paying job may offer more prestige, more interesting work, fewer hours, or more predictable hours. Even a choice driven by a sense of duty is consistent with utility maximization if we are willing to assume either that fulfilling this duty makes the worker happy or that failing to fulfill the duty would make the worker unhappy.

News reports tend to focus on the fabulous wealth achieved by some entrepreneurs and managers. However, studies suggest that entrepreneurs earn about the same amount on average as they would earn if they worked for a salary, and they earn much less once one adjusts for the risks that they take (investors generally demand higher returns to compensate for increased risk). Similarly, studies suggest that owners of private firms earn roughly the same rate of return as owners of publicly traded stock, and holders of private firms earn much less on a risk-adjusted basis. These results may be due to entrepreneurs' overly optimistic assessments of the prospects of their firms, but many economists suggest that something else is driving the entrepreneurs. More specifically, they suggest that entrepreneurs start firms in part because they receive non-pecuniary returns from control.

The precise nature of these non-pecuniary returns is uncertain. Entrepreneurs and


61. See, e.g., Tobias J. Moskowitz & Annette Vissing-Jorgensen, *The Returns to Entrepreneurial Investment: A Private Equity Premium Puzzle?*, 92 AM. ECON. REV. 745, 773-74 (2002) (providing an example of one study showing that the rate of return on equity in private firms is similar to that in public firms).
other managers may derive happiness from running a firm, particularly a firm with a strong reputation.62 They may also enjoy a sense of power from control, especially if they control a large firm.63 They may enjoy psychological satisfaction from the implementation of management policies, or "doing it my way."64 Jensen and Meckling offer an oft-quoted summary of other miscellaneous non-pecuniary benefits that accrue to managers: "the physical appointments of the office, the attractiveness of the secretarial staff, the level of employee discipline, the kind and amount of charitable contributions, personal relations (‗love,' ‗respect,' etc.) with employees, a larger than optimal computer to play with, [or] purchase of production inputs from friends."65

The private benefits of control may not be benign from the standpoint of shareholders as managers may use their control to pursue goals other than profit maximization.66 Henry Ford famously stated: "My ambition ... is to employ still more men; to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this, we are putting the greatest share of our profits back into the business."67 Similarly, in Facebook's registration statement, Mark Zuckerberg states: "Simply put: we don't build services to make money; we make money to build better services. ... I think more and more people want to use services from companies that believe in something beyond simply maximizing profits."68

This Article will not revisit the voluminous literature on whether it is appropriate for public corporations to pursue goals other than the maximization of share value.69

Some studies estimate that better governance terms can improve the value of


64. Holmén & Högfeldt, supra note 62, at 6 n.3.


66. See Bebchuk & Kahan, supra note 53, at 1090 (discussing the fact that control benefits could come from self-dealing or looting from the company).


69. See generally William T. Allen, Our Schizophrenic Conception of the Business Corporation, 14 CARDOZO L. REV. 261, 264 (1992) (discussing the question, "[f]or whose benefit are those in control of a corporation supposed to act?"); Einer Elhauge, Sacrificing Corporate Profits in the Public Interest, 80 N.Y.U. L. REV. 733 (2005) (arguing that the view that managers have a profit maximizing duty stemming from social efficiency is mistaken both descriptively and normatively); Lynn A. Stout, Why We Should Stop Teaching Dodge v. Ford, 3 VA. L. & BUS. REV. 163 (2008) (arguing that Dodge v. Ford is an example of a judicial mistake in interpreting the purpose of a corporation); EASTERBROOK & FISCHER, supra note 25, at 35–39 (arguing for a background rule that requires managers to maximize the long-run profits of the their firms); Jonathan R. Macey, A Close Read of an Excellent Commentary on Dodge v. Ford, 3 VA. L. & BUS. REV. 177 (2008) (discussing Stout's article on Dodge v. Ford and arguing that Stout overemphasized the Michigan Supreme Court establishing the sole purpose of the public corporation while making too little of the case by stating the decision is irrelevant).
publicly traded firms by as much as five percent,\textsuperscript{70} meaning that managers and controlling shareholders are sacrificing significant wealth by choosing strong anti-takeover devices. To take an extreme example, if better terms could have increased the value of Facebook by five percent, this would have enriched Mark Zuckerberg by roughly $1 billion.\textsuperscript{71} Some are skeptical of the importance of these non-pecuniary benefits, at least in the takeover context, arguing that “it is hard to justify multimillion dollar premia with the pure pleasure of command.”\textsuperscript{72} Yet perhaps it is not as hard as it would first appear. After all, wealthy individuals have spent millions (and even hundreds of millions) of dollars of their own money to try to secure the power and prestige that comes with an elected office.\textsuperscript{73} Economists commonly argue that the marginal utility of money declines with wealth. With wealth already measured in the billions of dollars,\textsuperscript{74} it is not clear that the founders of firms such as Facebook or Google or their heirs could hope to ever spend the additional wealth that might be earned through better governance terms. The founders may derive some happiness from the prestige that comes with running a more valuable firm, but they must balance this against the risk that they would lose prestige if they were ousted from control.

B. The Taxation of Pecuniary and Non-Pecuniary Benefits

The central argument of this Article stems from the idea that the government taxes the pecuniary returns from firm ownership more heavily than the non-pecuniary returns. Consider first the pecuniary returns. Corporations must pay tax on their income, managers must pay tax on their salary, and shareholders must pay tax on their dividends and on the appreciation of their stock. These taxes may not be immediate or large. Many new firms will not have taxable income, and taxpayers can use planning strategies to minimize these taxes. Firms can use strategies like the “double Irish” to shield much of their income,\textsuperscript{75} and a manager can structure her salary and dividend payments to postpone the realization of any gains. However, we should not push this argument too far. While the effective corporate tax rate is much less than 35\%, for most firms it is not

\textsuperscript{70} See, e.g., Cremers & Ferrell, supra note 24, at 24–25 (estimating that the adoption of a poison pill reduces firm value by five percent).

\textsuperscript{71} At the time of the IPO, Zuckerberg owned 503.6 million shares of Facebook. At the IPO price of $38 per share, his stake was worth $19.1 billion. A five percent increase above that IPO price would be worth an additional $955 million. David De Jong & Devon Pendleton, Facebook IPO Makes Zuckerberg Richer than Google Founders, BLOOMBERG (May 18, 2012, 11:35 AM), http://www.bloomberg.com/news/2012-05-17/facebook-ipo-makes-zuckerberg-richer-than-google-founders.html.


\textsuperscript{73} See, e.g., Dan Haar, Super-Rich Candidates Mostly Can’t Buy Wins: Only 4 of 32 Who Spent $1 Million of Own Money Got Seats, CHI. TRIB., Nov. 8, 2010, at 38 (“Thirty-two people . . . spent at least $1 million of their own fortunes on campaigns for Congress . . . . In Florida, Republican Rick Scott wrote checks totaling $73 million to his campaign for governor . . . . Bloomberg . . . unleashed $267 million on his three campaigns for mayor.”).

\textsuperscript{74} See De Jong & Pendleton, supra note 71 (discussing Mark Zuckerberg’s wealth following the Facebook IPO).

\textsuperscript{75} Jesse Drucker, Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes, BLOOMBERG (Oct. 21, 2010, 5:00 AM), http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-us-revenue-lost-to-tax-loopholes.html.
A manager can postpone the realization of some of her pecuniary gains, but the Tax Code will at least try to assess a tax upon a realization event. If the manager sells her stock, she must pay capital gains taxes. If she gives her stock away (or dies), she must pay gift or estate taxes.

Next, consider the taxation of non-pecuniary benefits. The government makes no effort to tax the non-pecuniary benefits of control that the manager receives while she remains in power; she can realize these returns immediately, tax free. The government does, however, at least try to tax the non-pecuniary benefits of control that are passed onto another party. If she sells a controlling block of shares, the value of control should be impounded in the price and therefore taxed. If she bequeaths her shares to an heir, the Internal Revenue Service will, in theory, include the control premium in the estate tax calculation. However, the manager may expect to retain control of her firm for quite some time, making these taxes of secondary importance. In addition, she may expect to remove the anti-takeover protections when she retires, allowing her shares to appreciate. On the other hand, the Tax Code gives her an incentive not to do so. When the manager steps down, the firm will need to hire a replacement. If the new manager also values the non-pecuniary benefits of control, the presence of anti-takeover devices may allow the firm to employ her at a lower cost. Significantly, the prospective manager should consider her after-tax income when weighing the combination of control and combination offered to her. To the extent that the market for new managers is competitive, the firm and the existing manager may capture some or all of the tax preferences created by the failure to tax non-pecuniary benefits.

V. CORRECTIVE ACTION IN AN IMPERFECT WORLD

Any tax on pecuniary returns distorts incentives; this is a general problem of taxation. Scholars have suggested a number of corrective actions in other contexts in which this problem arises. Kaplow suggests that the government could mitigate the distortions caused by the income tax by taxing complements to leisure such as swimsuits. Mankiw and Weinzierl suggest (perhaps facetiously) that the government can mitigate these distortions by basing the income tax in part on proxies for an individual’s potential income such as an individual’s height (taller individuals tend to earn more). However, governments rarely, if ever, adopt these proposals in part because they fear that the proxies are poor or that the corrective taxes create their own problems. For example, education serves as a good proxy for potential income, but a tax based on education would obviously distort the decision of when to enter the workforce.


78. The fact that the government may tax the transfer of control may also distort how long the manager chooses to retain control of her firm, but that is a topic for another article.

79. See Louis Kaplow, Taxing Leisure Complements, 48 ECON. INQUIRY 1065, 1069 n.9 (2010) (discussing the optimality of taxing leisure complements and subsidiary substitutes).

The government could take corrective actions to address the distortions created by a tax on the pecuniary returns from starting or running a firm, but these corrective actions may not be feasible and may create their own distortions. One approach would base taxes on estimates of the potential value of the firm rather than the actual value of the firm. The government already uses a variant of this strategy in the estate tax context. One common estate tax planning strategy is to saddle assets with limitations that reduce their value at the time of transfer and then remove these limitations after title has passed to the heirs.\(^{81}\) The government tries to combat this strategy by assessing the estate tax on the value of an asset independent of these limitations.\(^{82}\) Similarly, the government could assess an income tax on what the firm would have earned if it had optimal governance terms instead of what the firm actually earned. The government could assess capital gains and transfer (gift and estate) taxes based on the potential value of the shares (the value of the firm if it had optimal governance terms) rather than the existing value of the shares. These taxes should be assessed on controlling and non-controlling shareholders alike. If capital markets are efficient, the prospect of higher taxes on non-controlling shares will reduce the amount that investors are willing to pay, and the manager will bear the economic cost of the tax. Unfortunately, the government almost certainly lacks the information necessary to determine the potential income of the firm and probably cannot estimate the potential value of a firm's shares in a cost-effective manner; these approaches may be no more plausible than assessing income taxes based on an individual's potential income instead of her actual income.\(^{83}\)

Perhaps a more feasible approach would be for the government to simply ban anti-takeover protections that it found to be unreasonable. For example, Delaware courts could abandon their largely deferential approach to anti-takeover protections and view these provisions with a more jaundiced eye. Alternatively, the government could assess an additional tax on public corporations based on the anti-takeover provisions that they adopt. Again, if capital markets are efficient, the entrepreneurs would bear the cost of these taxes because they would reduce the amount that investors are willing to pay for shares in the firm. Whether to use command and control (prohibiting inefficient terms) or taxation (pricing terms) to correct market inefficiencies is a standard problem in government regulation, and the preferred answer largely depends on the information available to the government.\(^{85}\) A full exploration of this topic is beyond the scope of this Article. However, if the government is confident in its ability to choose efficient terms of corporate governance but not in its ability to assess the damage caused by poor terms, it should choose the terms directly. If it is confident in its ability to price the distortion caused by taxation but not in its ability to choose efficient terms of governance, it should


\(^{83}\) See supra notes 46–48 and accompanying text (noting that optimal tax theory suggests that governments tax actual income because they cannot accurately estimate potential income).


adopt an offsetting tax.

While these corrective devices offer some promise, they may be very difficult to implement; the government would have to estimate the appropriate level of tax or the efficient governance terms. In addition, the corrective devices could create their own distortions because a manager's desire for control has effects beyond the choice of governance terms prior to an initial public offering. Some academics argue that entrepreneurs must choose between being rich (wealth) and being king (control). Many entrepreneurs have an outstanding idea for a product but lack the management skills and financial resources to bring this product to market quickly. If they wish to maximize the value of the firm, they must sell a stake in their firm to outside investors and new management. This creates the risk that they will lose control and be displaced. As a result, some entrepreneurs refuse or postpone searching for outside financing and management help, delaying the launch of their idea and reducing their wealth.

Prohibiting or placing a tax on anti-takeover protections used by public firms would exacerbate these and similar problems. The prohibition or tax could cause the entrepreneur to take other steps to retain control such as delaying an initial public offering, selling fewer shares, or delaying future expansion efforts that require new funding. In fact, some scholars have argued that anti-takeover protections may be efficient precisely because they prevent the entrepreneur from taking these steps. This is not to say that the distortions a tax on anti-takeover protections create would necessarily be larger than those our existing tax system creates. There are no easy choices in a second-best world.

VI. CONCLUSION

Much of the corporate governance literature suggests that anti-takeover provisions are inefficient and that newly public firms will have efficient terms of corporate governance. However, one of these claims must be wrong because empirical studies demonstrate that anti-takeover protections are common in newly public firms. The existing literature offers a number of possible explanations for this puzzle but omits any discussion of the Tax Code.

Taxes distort incentives. If the government taxes labor income but does not tax leisure, the taxpayer will choose too much leisure. If the government taxes returns but

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86. See generally Noam Wasserman, Rich Versus King: The Entrepreneur's Dilemma, ACAD. MGMT. ANN. MEETING PROC., Aug. 2006, at 1 (arguing that many entrepreneurs must make a difficult choice between being wealthy and having control).
87. See id. at 2, 5 (describing the tradeoff between building a valuable company and maintaining control); Harry J. Sapienza et al., The Self-Determination Motive and Entrepreneurs' Choice of Financing, in COGNITIVE APPROACHES TO ENTREPRENEURSHIP RESEARCH 105, 111-13 (Jerome A. Katz & Dean A. Shepherd eds., 2003) (stating that "financing sought and accepted . . . is affected by the mix of wealth and self-determination motives").
88. See Bebchuk, supra note 9, at 730-33 (devising a model to illustrate efficiencies); see also Wasserman, supra note 86 (discussing how retaining control can affect value).
89. See supra notes 23-24 and accompanying text.
90. See supra notes 25-26 and accompanying text.
91. See supra notes 27-29 and accompanying text.
92. See supra notes 46-48 and accompanying text.
does not tax liquidity, the taxpayer will choose too much liquidity. This Article extends this basic argument to the choice of corporate governance terms. If the government taxes the pecuniary returns from running a firm (wealth and income) but not the non-pecuniary returns (other pleasure that a manager can derive from control), then managers will choose corporate governance terms that give them too much control.

Whether this tax distortion is economically significant is an open question. One must believe that the non-pecuniary benefits of control are significant and that these benefits are taxed less effectively than the pecuniary returns from a firm. This Article argues that these assumptions are plausible but leaves empirical support to future scholarship. Whether the government should do anything about this distortion is another matter. The government could take corrective action by prohibiting unreasonable anti-takeover provisions, taxing them, or by adjusting taxes to reflect the value of a firm without the anti-takeover provisions. However, these corrective adjustments may require information that the government does not have and may create their own distortions. There are no easy choices in a second-best world of limited information.

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94. See supra Part IV.
95. See supra Part V.