

**EXIT, VOICE, LIABILITY, AND SCOPE:  
TRADEOFFS IN  
CONSTRAINING AGENCY COSTS**

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## Abstract

The contemporary literature on organizational law and economics focuses with singular intensity on managerial agency costs. We analyze the four principal mechanisms employed to limit those costs, in both commercial and non-commercial organizations, since the Renaissance, with a particular focus on relationships among the mechanisms.

Two of the four mechanisms -- the right to withdraw from the firm, and the right to participate in its management -- are, respectively, analogous to the late Albert Hirschman's famous concepts of "exit" and "voice." In contrast to conventional interpretations of Hirschman, however, we find that these two mechanisms are typically *complements* rather than *substitutes*: strong exit rights generally accompany strong voice. The same is true, moreover, of our third mechanism, "liability," which is the right of the organization's owners (or principal beneficiaries) to bring suit against the organization's managers for breach of fiduciary duty. That is, managers constrained by strict fiduciary duties are also typically constrained by stronger owner rights of exit and voice. It is only in our fourth constraining mechanism -- limiting the "scope" of the authority delegated to managers -- that we find much substitutability with the other three mechanisms -- and even limited scope is, in important cases, employed where managers are also constrained by strong owner rights of exit, voice, and liability.

This strong complementarity among devices for constraining the actions of managers, we suggest, is primarily a response to another fundamental agency problem in organizational design: the exploitation of non-controlling owners (or beneficiaries) by controlling owners. Although strong owner rights of exit, voice, and liability can help assure that an organization's managers serve its owners well as a class, these mechanisms can also be used to redistribute value among the class of owners itself. Apparently these conflicts of interest among owners commonly overshadow managerial agency costs, which appear to be, in general, only a second-order problem in organizational design.

# INTRODUCTION

The contemporary literature on organizational law and economics, and particularly on corporate governance, has long focused with singular intensity on the managerial agency problem – that is, on the legal and contractual mechanisms by which the managers of an organization can be induced to act in the best interest of the organization’s owners or intended beneficiaries. Our object here is to explore what can be said, of a systematic nature, about these various mechanisms. In particular, we identify and describe the four types of mechanisms for assuring efficient management that seem most commonly employed in the types of organizations, both commercial and non-commercial, that have been dominant in Western society since the Renaissance. We describe and seek to explain the ways in which these mechanisms are deployed in organizations today, and the ways in which they have evolved over time.

There is surprisingly little literature in either economics or law that addresses these issues in general terms. Among the most prominent exceptions are recent books and articles, principally but not exclusively in the economic history literature, by Blair, Goshen, Guinnane, Harris, Lamoreaux, Macchiatti, Morley, Ribstein, and Rosenthal,<sup>1</sup> as well as some work of our own with Squire.<sup>2</sup>

## Hirschman’s Exit-Voice Tradeoff.

As our title suggests, we follow many other students of organizational structure in taking some inspiration from the late Albert Hirschman’s prominent and suggestive book on Exit, Voice, and Loyalty.<sup>3</sup> In particular, among the four control mechanisms that we explore there are two that closely resemble, respectively, the “exit” and “voice” that Hirschman immortalized in his famous title. In contrast to Hirschman, however, we argue that exit and voice typically serve as complements rather than as substitutes in the structure of organizations.

In essence, Hirschman made a simple point. At the time he wrote, the conventional wisdom among economists was that market forces were the principal disciplining mechanism for organizations. More specifically, if an organization’s performance began to decline, patrons would cease dealing with the firm—or in Hirschman’s terms, “exit” the organization—in favor of a competitor. The result would be either to stimulate the declining organization to improve, or to lead to its replacement. Hirschman thought that, in many circumstances, this view was mistaken,

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<sup>1</sup> See, e.g., Timothy Guinnane, Ron Harris, Naomi Lamoreaux, & Jean-Laurent Rosenthal, *Ownership and Control in the Entrepreneurial Firm: An International History of Private Limited Companies* (Yale Economic Growth Center Discussion Paper No. 959, 2007); Margaret Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA LAW REVIEW 387 (2003); Naomi Lamoreaux & Jean-Laurent Rosenthal, *Corporate Governance and the Plight of Minority Shareholders in the United States before the Great Depression*, in Edward Glaeser & Claudia Goldin, eds., CORRUPTION AND REFORM: LESSONS FROM AMERICAN’S ECONOMIC HISTORY (2006); Ron Harris, INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION 1720-1844 (2000); Larry Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183 (2004).

<sup>2</sup> Henry Hansmann, Reinier Kraakman, & Richard Squire, *Law and the Rise of the Firm*, 119 HARVARD LAW REVIEW 1333 (2006). [ALSO SQUIRE IN YALE L.J.]

<sup>3</sup> ALBERT HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970).

or at least seriously incomplete. His iconic example was the Nigerian State Railway, which at the time had an effective monopoly and provided poor service. Other economists suggested that the best stimulus to improvement would be to provide the railway with competition. Hirschman, however, thought that the contrary might be true. In the absence of an exit channel, patrons would presumably use all the political and personal influence that was available to them—“voice” in Hirschman’s terms—to improve the quality of the railway’s service.

Hirschman emphasized not only that voice was an alternative to exit as a means of disciplining organizations, but that the two often act as strong substitutes. Providing greater opportunity for exit could undercut voice, which might often be the more effective disciplining mechanism. Hence, there is a trade-off between exit and voice. Indeed, exit tends to crowd out voice. It follows, Hirschman suggested, that there is frequently good reason to limit exit by binding patrons more closely to an organization that serves them—that is, by increasing their “loyalty” to the organization.

Although Hirschman was primarily concerned with the relationship between an organization and its customers, it seems natural to apply the same analysis to the relationship between the owners of an organization and its managers – the familiar managerial agency problem.. Examples include not just the tension between shareholders and managers in a Berle-Means publicly-traded business corporation – to which in fact Hirschman’s analysis has often been applied<sup>4</sup> -- but also the analogous relationship in many other types of organizations: between investors and investment managers in a mutual fund<sup>5</sup>, between beneficiaries and managers of a nonprofit organization<sup>6</sup>, and between private litigants and the courts that hear their cases<sup>7</sup> (or more generally between citizens and their government<sup>8</sup>). For these applications, Hirschman’s “voice” is commonly interpreted as the strength of the voting rights given to the organization’s owners or beneficiaries, and “exit” is taken to be the ease with which an owner or beneficiary can withdraw from the organization<sup>9</sup>.

As we show here, however, a broad survey of the dominant organizational forms in present and past Atlantic societies reveals that – contrary to the exit/voice trade-off that is commonly attributed to Hirschman -- exit and voice generally appear, not as substitutes, but as strong complements. When an organization’s owners (or beneficial owners, as in a nonprofit) have strong voice (voting rights), they commonly have an easy means of withdrawing from the organization as well.

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<sup>4</sup> E.g., John Coffee, Liquidity versus Control: The Institutional Investor as Corporate Monitor, 96 Columbia L. Rev. 1277 (1991); Alex Edmans, Blockholders and Corporate Governance, 6 Ann. Rev. Fin. Econ. 23 (2014); Alessio Paces, Exit, Voice, and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance, Erasmus Law Rev (Dec. 2016).

<sup>5</sup> Mutual funds today are organized as Massachusetts Business Trusts, Delaware Statutory Trusts, or Maryland Corporations. The state statute under which the Fund is organized matters much less than the federal law regulating the necessary features of the fund and its relationship to Fund Advisers, i.e., the Investment Company Act and the Investment Advisers Act of 1940.

<sup>6</sup> []

<sup>7</sup> [Dammann and Hansmann; Ron Daniels?]

<sup>8</sup>

<sup>9</sup> [Examples]

## An Extension: Liability and Scope.

To gain greater perspective on this correlation, we extend Hirschman's analysis by examining two additional mechanisms for controlling an organization's managers. The first of these, which we term "liability," reflects the ability of an organization's owners or beneficiaries to bring a lawsuit against the organization's managers for breach of fiduciary duty. (Although, for alliteration, we have used the term "liability" in our title as a substitute for Hirschman's "loyalty," the meanings of these two terms, as we use them here, have little in common.) The second, which we term "scope of authority" or simply "scope," has generally been neglected in the literature on enterprise organization. It reflects the degree of latitude or discretion given the firm's managers in determining what the organization will do and how it will be done.

With respect to liability, our analysis again reveals a striking complementarity among alternative mechanisms for assuring managerial accountability. The strength of the fiduciary duties to which the managers of any given type of organization are held correlates positively and strongly with the strength of the exit (withdrawal) and voice (voting) rights granted the organization's (beneficial) owners. Only when we come to scope do we see substantial trade-offs with the other three control mechanisms. And, even with respect to scope, that trade-off is often lacking. In sum, the most important mechanisms that serve to limit the managerial agency problem appear to be, in general, positively correlated: when one mechanism takes a strong form, so do the others.

The major reason for this complementarity, we suggest, lies in another fundamental agency problem in organizational design, which is the exploitation of one subset of the organization's owners (or designated beneficiaries) by another. Though exit, voice, liability, and scope can often be adjusted effectively to assure that an organization's managers serve its owners well as a *class*, these mechanisms – and particularly the first three of them – can also be used to redistribute value *among the owners themselves*. And this conflict of interest among owners commonly overshadows the problem of assuring the responsiveness of the organization's managers to its owners as a whole.

Broadly speaking, owner-versus-owner agency costs can take two forms. The first of these is *inefficient decisions*, as where controlling owners of a firm engage in tunneling, choosing projects not for their overall return to the firm but for the return they will yield to the controlling owners alone. The second is *inefficient decision-making processes*, as where owners with disparate interests in the firm seek to gain and exercise control over it through efforts to build and maintain coalitions that will serve their private interests..

Indeed, we think that the pattern of organizational responses that we see reflects a more general characteristic of organizational design, namely that the managerial agency problem is only a second-order concern that is typically dominated by the two other principal agency problems in organizations, which are opportunism on the part of

the organization with respect to its creditors, and opportunism on the part of the organization's controlling owners toward its non-controlling owners.

We organize our analysis by examining relationships among exit, voice, liability, and scope across the principal organizational forms in use at three key historical times and places: Italy (Florence) circa 1450, the United States circa 1900, and the United States today.<sup>10</sup>

## Survivorship

As a matter of methodology, we assume that organizational forms in common use are, in general, more efficient than those that are not. This is a form of survivorship test: it assumes that, in the free enterprise economies on which we are focusing, the market for organizational forms will commonly select those that are relatively efficient. This assumption is of course most plausible for business entity forms as compared to political, religious, or familial institutions, although there is arguably pressure for selection of relatively efficient forms among the latter institutions as well.<sup>11</sup> Perhaps the best test of this assumption is, however, simply the extent to which it provides a convincing and useful framework for understanding the role and structure of the various types of organizations that we observe.

We discern, very broadly speaking, two kinds of factors that affect the efficiency of any given organizational form. There are, first, those that we term *external* or *contextual* factors that involve, in large part, the types of functions performed by the organization and the technology available for performing those functions. These contextual factors include, for example, the capital intensity of the production techniques available to the organization, the firm-specificity of its investments, and the transparency and competitiveness of the product and factor markets in which it deals. External factors also include what we term the *set of available transactional technologies*, such as the availability of courts and legal professionals, the size of jurisdictions, and the ease with which assets can be valued or tracked.

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<sup>10</sup> We limit ourselves to Atlantic societies beginning in the high Middle Ages, which have been conspicuous for their individualism and entrepreneurialism. We are not trying to explain the whole world, or all of history even for the Atlantic societies. Rather, we are beginning with "the great divergence" between East and West in the middle ages, and following only one of the two diverging lines in social organization. For the latter (Atlantic) line of evolution, organizational structures have arguably evolved under relatively strong pressures for efficiency. This is in contrast, for example, even to ancient Roman society, about which we have written elsewhere.

<sup>11</sup> This survival-of-the-most-efficient assumption is relatively weak and easy to defend with regard to forms for which the law clearly provides: if a given type of activity is commonly undertaken by business corporations rather than by partnerships, and the law provides easy access to both of these standard forms in the period in question, then it seems reasonable to assume that the corporate form is the more efficient one for that activity. (This logic doesn't directly apply to the extent that the forms involved have different effects on third parties. Tort liability is an example. See Hansmann and Kraakman, 1990.) The assumption is stronger and more controversial when it comes to forms for which the law does not provide. If, for example, the law does not offer a standard legal form for forming limited partnerships at a given moment, then the fact that a given activity is undertaken through general partnerships or business corporations rather than through limited partnerships might not be thought strong evidence that use of the latter form would be less efficient. For a variety of reasons – such as lack of familiarity, interest group pressures, or religious and political ideology – law may not always provide for a full set of efficient forms.

Second, we identify what we term *internal* or *coherence* factors. These concern the ways in which the structural features we are concerned with (exit, voice, liability, and scope) interact with each other, for example by complementing, substituting for, or conflicting with each other.

Clearly, both types of factors play a role in determining the structural attributes of organizations. Some firm attributes are largely a response to external factors. To take a familiar example, some organizations use production processes that require large investments in organization-specific capital; for these organizations, limitations on owner exit are crucial. Other firm attributes seem to arise largely for their internal consistency with the externally determined attributes. For example, in organizations with constricted exit rights, limited liability has particularly strong advantages (for familiar reasons we review below). While we are concerned here with both external and internal factors, we focus more intensely on the latter, which are the least studied.