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Abstract

For much of the last three decades, the dominant perspective in corporate law scholarship and policy debates about corporate governance has adopted the view that the sole purpose of the corporation is maximizing share value for corporate shareholders. But the corporate scandals of 2001 and 2002, followed by the disastrous performance of financial markets in 2007-2009, has left many observers uneasy about this prescription. Prominent advocates of shareholder primacy such as Michael Jensen, Jack Welch, and Harvard's Lucian Bebchuk have backed away from the idea that maximizing share value has the effect of maximizing the total social value of the firm, noting that shareholders may often have incentives to take on too much risk, thereby increasing the value they capture by imposing costs on creditors, employees, taxpayers, and the economy as a whole.

In response to the dramatic demonstration of the problems with shareholder primacy, some scholars and practitioners have considered the "team production" framework for understanding the social and economic role of corporations and corporate law (Blair & Stout, 1999) as a viable alternative. Whereas the principal-agent framework provided a strong justification for the focus on share value, the team production framework can be seen as a generalization of the principal-agent problem that is symmetric: all of the participants in a common enterprise have reason to want all of the other participants to cooperate fully. A team production analysis thus starts with a broader assumption that all of the participants hope to benefit from their involvement in the corporate enterprise, and that all have an interest in finding a governance arrangement that is effective at eliciting support and cooperation from all of the participants whose contributions are important to the success of the joint enterprise. Insights from a team production analysis provide a rationale for a number of features of corporate law that are problematic under a principal-agent framework.

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Introduction

Should corporations be managed for the sole purpose of maximizing share value for corporate shareholders? While for much of the last three decades, the dominant perspective in corporate law scholarship and policy debates about corporate governance has adopted this view, the corporate scandals of 2001 and 2002, followed by the disastrous performance of financial markets in 2007-2009, has left many observers uneasy about this prescription. A number of strong shareholder value advocates have shifted their recommendations. Michael Jensen (2001), one of the leading advocates of share value maximization in the 1980s and 1990s, has recognized that shareholder value can be increased without adding to social wealth by extracting value from other corporate participants, such as creditors. He now argues instead that corporate managers should maximize "not just the value of the equity but also . . . . the market values of all other financial claims including debt, preferred stock, and warrants" (Jensen, 2001). Likewise, former GE CEO Jack Welch, considered by some to be the "father of the 'shareholder value' movement" among corporate boards and managers now says that "shareholder value is a result, not a strategy . . . your main constituencies are your employees, your customers, and your products" (Guerrera, 2009). Among academics, Lucian Bebchuk, one of the most outspoken and prolific advocate of enhanced shareholder rights now concedes that "the common shareholders in financial firms do not have an incentive to take into account the losses that risks can impose on preferred shareholders, bondholders, depositors, taxpayers underwriting governmental guarantees of deposits, and the economy" (Bebchuk & Spamann, 2010: 2-3).

As advocates back away from a commitment to shareholder value maximization as the exclusive goal of corporate governance, some scholars and practitioners have considered the "team production" framework for understanding the social and economic role of corporations and corporate law (Blair & Stout, 1999) as a leading candidate for a viable alternative (Hansmann & Kraakman, 2000-2001:447-448; Hamilton & Macey, 2009: 21-24; *Citizens United* v. *Federal Election Commission*, 130 U.S. 876 (2010), dissent, at note 72; Frey & Osterloh (2005); Gelter (2009); Daily et. al., 2003; Boatright, 2009; Sharfman & Toll, 2009; Bainbridge 2008). The team production problem in economics refers to the problem of organizing productive activity that involves complex inputs from a number of different people (Alchian & Demsetz, 1972) – a problem that pervades nearly all business enterprises. The problem is how to get the contributors of all the different inputs to fully cooperate with each other in situations that don't lend themselves to drafting and enforcing complete, detailed contracts – precisely the situations most likely to lead to production being governed within a firm rather than by contract (Williamson, 2002).

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The team production framework challenges the "principal-agent" framework, which dominated corporate law and economics scholarship in the 1980s and 1990s, and continues to be influential today (Jensen & Meckling, 1976; Easterbrook & Fischel, 1992; Shleifer & Vishny, 1997). The principal-agent framework provided a strong justification for the focus on share value. This framework is premised on the idea that the central problem to be solved in the governance of corporations is the problem of getting the managers and directors of the corporation to be faithful "agents" of shareholders. Shareholders are understood in the model to be the "owners" or "principals" of the business enterprise undertaken by the corporation. The principal-agent framework has been adopted by many scholars as a way to model the problem first identified by Adolf Berle and Gardiner Means (1932) as the "separation of ownership from control." Scholars who have tried to explain or analyze corporate law using the principal-agent approach, therefore, have generally assumed that the social goal of corporations is to generate profits for shareholders, an assumption which has been called "shareholder primacy." Using the principal-agent framework, scholars have analyzed a number of features of corporate law, from shareholder voting rights, to executive compensation arrangements, to takeover rules, in terms of whether they serve to maximize the value of equity shares, or to provide incentives to corporate directors and managers to do this (cites to other articles in the handbook).

The team production framework, by contrast, does not incorporate an a priori assumption about who, among parties to a common enterprise, should be regarded as the "principal" and who should be regarded as the "agent." For this reason, it can be seen as a generalization of the principal-agent problem that is symmetric: all of the participants in a common enterprise have reason to want all of the other participants to cooperate fully. A team production analysis thus starts with a broader assumption that all of the participants hope to benefit from their involvement in the corporate enterprise, and that all have an interest in finding a governance arrangement that is effective at eliciting support and cooperation from all of the participants whose contributions are important to the success of the joint enterprise.

Insights from a team production analysis provide a rationale for a number of features of corporate law that are problematic under a principal-agent framework. As such, it does a somewhat better job of explaining how corporate law actually works, as well as a better normative framework for understanding what corporate directors are supposed to do. In Part I below, I explain the economic theory of teams, and review various institutional arrangements that, in theory at least, can help solve the contracting problems that arise in team production. In Part II, I review six features of the corporate form that distinguish corporations from other organizational forms. While a principal agent analysis of these features suggests that most of them would tend to exacerbate agency costs rather than reduce them, I argue that these features of modern corporations may provide a remedy to the mutual cooperation problems that arise in team production. In Part III, I discuss several recent developments in corporate law that have tilted in the direction of shareholder primacy, even as corporate law scholarship has increasingly recognized that maximizing value for shareholders of corporations does not always lead to the optimal social outcome. In Part IV, I address some of the criticisms that have been aimed at the team production framework and argue that those problems are no more troubling than the problems that plague shareholder primacy.

I. The Economic Theory of Teams and Team Production

The team production problem is the economic problem that arises when a productive activity involves multiple parties, each contributing complex inputs that are difficult to contract over. Alchian and Demsetz (1972) defined team production as "production in which 1) several types of resources are used . . . 2) the product is not a sum of separable outputs of each cooperating resource . . . [and] 3) not all resources used in team production belong to one person." (Alchian & Demsetz, 1972: 779).

When these conditions hold (which is likely to be often in the context of business ventures), it may not be possible to organize this kind of production by contracting over the inputs, because it may not be possible to clearly identify and measure the inputs ex ante. Likewise, equal-sharing or fixed-sharing contracts would also be problematic because they would give each participant an incentive to shirk, or to free ride on other participants. This is because, under an ex ante rule, each participant will get the same share of output whether she fully contributes or not. On the other hand, if the participants try to write open-ended contracts in which the output shares will be determined ex post, all will have incentives to expend resources in "rent-seeking" – haggling and competing for a larger share of the pie once the size of the pie has been determined (Blair & Stout, 1999: 265-266).

In their initial analysis of the team production problem, Alchian and Demsetz argued that a solution is to establish a hierarchy, in which one member of the team specializes in monitoring all of the other members to make sure that all are contributing adequately (Alchian & Demsetz, 1972: 781). To be sure that the monitor has appropriate incentives to do this well, Alchian and Demsetz proposed that the monitor should have hiring and firing authority, that the other team members should be employees of the monitor who are paid according to their opportunity costs, and that the monitor should receive all the economic surplus or profits created by the enterprise.

Alchian and Demsetz argued that this solution to the team production problem provides a "theory of the firm," and that it helps explain why people organize productive activity in "firms." Their proposed solution, however, resembles an individual proprietorship, where the same party has both "ownership" and "control" over the business. It does not resemble a corporation in which the parties who have hiring and firing authority (as well as other decision-making authority) are not the same as the parties who capture the profits from the enterprise. Thus this initial attempt to analyze the team production problem does not shed light on what distinguishes corporate law from law governing other business forms.

Subsequent analyses of the team production problem have generally focused on production that requires each team member to contribute some specialized skills, or make specialized ("firm-specific") investments in the joint enterprise. When team members all have team-specific investments at risk, the contracting problem is especially hard to solve, and participants generally cannot write complete contracts to cover all of the possible scenarios that the business will face over its life. Nonetheless, by bringing some real world complexity to the economic models, the "solutions" that economic theorists produce begin to look more like real

world firms. Economist Oliver Hart and various co-authors (Grossman & Hart, 1986; Hart & Moore, 1990; Hart, 1988; Hart, 1989) have proposed, for example, that the contracting problem can be solved by assigning property rights over assets used in production to one of the participants. This gives the "owner" the right to make decisions that have not previously been specified by contract. But which of the participants should be the "owner"? Hart and his coauthors concede that there is no first-best solution to this problem if multiple parties must make specific investments. The best solution that can be achieved, they claim, is to assign property rights over the enterprise to the party whose specialized investments are most critical to the success of the enterprise (Grossman & Hart, 1986: 708; Blair & Stout, 1999: 273).

This solution, however, may not be adequate if the contributions of more than one person are critical to the success of the enterprise. Moreover, the proposed solution again looks more like an individual proprietorship than a publicly-traded corporation in which control rights and rights to receive the residual benefits have been split up, with the former going to managers and the latter going, at least in part, to shareholders.

In considering a similar problem, economists Raghuram Rajan and Luigi Zingales (1998) note that assigning property rights over the firm's assets to one member of the team might not solve the problem at all if those rights also give the "owner" the right to sell the assets. This is because an "owner" who can sell the assets might be able to capture more of the team surplus by arranging to sell the assets rather than by making the critical specialized investments that she herself needs to make the team to be as productive as possible. Thus if one member of the team is given ownership rights (as Hart and co-authors propose), the other members of the team may be reluctant to make specific investments in the enterprise.

Rajan and Zingales (1998) suggest that instead of giving control rights to one team member, all of the team members might be better off if they agree to give up certain critical decision rights to an outsider, someone who is not a member of the team and has no other stake in the enterprise.[2] The decision-rights that the outsider should get include the right to choose the

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[2] The role of outsider in Rajan and Zingales's model is similar to, but not identical to, the role of the "budget breaker" in an early effort by Bengt Holmstrom (1982) to model a solution to the team production problem. Holmstrom studied the problem that arises if the members of the team bring specialized skills, or must make specialized ("firm-specific") investments. Holmstrom asked whether it would be possible to write a contract as a function of the output of the enterprise (rather than trying to contract over inputs, which would be hard to monitor) that provides incentives that will discourage all team members from shirking. His conclusion, sometimes known as "Holmstrom's impossibility theorem," (See: http://en.wikipedia.org/wiki/Holmstr%C3%B6m's_theorem.) was that to provide correct incentives for team members, each team member must bear the full cost of his own shirking. But he showed that it is mathematically impossible to create a contract that allocates the full cost of each team member's shirking to that team member, unless all team members are punished for the shirking of any one team member shirks. The math is complicated, but the intuition is simple. If there are, say, n team members, and each team member is to receive 1/n of the total output, then all team members would have an incentive to shirk, because each would bear only 1/n of the cost of shirking. The solution is to set a target output level, a level that can only be reached if no one shirks, then agree that each team member will receive 1/n of the output only if the output reaches the target level. If output fails to reach the target level, this would be taken as evidence that at least one team member shirked, say by withholding some fraction, α, of the expected contribution. Since a monitor will not be able to discern which team member shirked, all team members would have their compensation cut by α. This would effectively punish the shirker (so the shirker would not have an incentive to shirk), but it would also mean that n*α of the output would not be distributed. What should happen to this left-over output? Holmstrom's solution requires that some outsider be solicited who would serve as what he called a "budget breaker" (Holmstrom, 1982: 325). That

members of the team (hiring and firing rights), and the right to allocate economic surpluses created by the team. But this outsider would not be an "owner" since it is important that she may not lay claim personally to the assets of the enterprise, nor be able to sell those assets. The outsider in such an arrangement, according to Rajan and Zingales (1998), should be compensated with a small fraction of the total surplus created by the enterprise, to give her an incentive to choose the team that can generate the largest surplus.

Rajan and Zingales (1998) interpret their decision-maker model as offering an explanation for the role of outside shareholders in publicly-traded corporations. But the role played by their decision-maker does not resemble the role of outside shareholders in actual corporations. Outside shareholders are highly unlikely to be involved in most decisions. Blair and Stout (1999), instead, propose that the role of outside decision-maker identified by Rajan and Zingales (1998) looks more like the role played by a board of directors in a publicly-traded corporation. Directors do not own the assets of a corporation, and they may not sell those assets and pocket the proceeds. They could, acting as a body, direct the managers to sell the assets, but the proceeds of such a sale would go to the corporation, not to the directors. Directors (except for so-called "inside directors" who are members of the management team) are usually generalists who do not make committed specialized investments in the firm. But corporate law provides that they are the ultimate decision-makers for the corporation. Thus by starting with a symmetric team production problem, with its agnostic perspective about whose interests should be served by a corporation, rather than with an asymmetric principal-agent problem in which shareholders are assumed to be the principals, Blair and Stout argue that a role for an independent board of directors in a corporation, with substantial decision-making authority, emerges endogenously.[3] The separation of control rights and decision rights from the ownership of assets is, therefore, not an infirmity of the corporate form that needs to be corrected or offset by other institutional arrangements, it is, under a team production analysis, an essential aspect of the corporate form that makes it attractive for organizing certain kinds of productive enterprises.

II. The Corporate Form as a Solution to the Team Production Problem

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person's only role would be to take the excess output when some team member shirks. Holmstrom argued that his model explained why it might be beneficial to separate ownership from control in capitalist business enterprises, but his solution does not look quite like any institutional arrangements that we see in practice. In fact, if the budget breaker is assumed to be a person, this solution would have the perverse effect of creating a situation in which it would be in the interest of the budget breaker to conspire with one of the team members to shirk a bit, to ensure that the team does not meet its target level of output. The Holmstrom solution, hence, has not often been discussed as part of the economics of corporate law, although Blair and Stout (1999) suggested that the corporation itself – a legal person that cannot conspire on its own behalf – could serve as the budget breaker by retaining output – failing to pay dividends or give raises, for example – when output is low.

[3] Oliver Williamson (1985: 306) has also argued that the institution of the board of directors "arises endogeneously, as a means by which to safeguard the investments of [shareholders] who face a diffuse but significant risk of expropriation." Steven Bainbridge (2002: 202), has made a similar point, though for different reasons. "Separating ownership and control by vesting decision-making authority in a centralized nexus distinct from the shareholders and all other constituents is what makes the large corporation feasible," Bainbridge says. It should not be surprising that some of the same institutional arrangements might arise under team production analysis as well as uder principal-agent analysis because, as noted earlier, team production analysis is a generalization of principal-agent analysis (or, alternatively, principal-agent analysis is a special case of team production analysis). But in both Williamson's and Bainbridge's analysis, the board of directors would be answerable to shareholders, whereas corporate law in the U.S. typically makes boards quite autonomous.

Corporate law scholars have identified a number of features that distinguish corporations from other business organizations. In recent years, business entity law has evolved to permit business people to form a growing variety of hybrid organizational forms that combine features from partnerships with features more typical of corporations. But to understand why business organizers might want to choose a corporate characteristic rather than a partnership characteristic, it is useful to consider the function of each feature. This part reconsiders several widely-recognized features of classical business corporations. When these features are assessed within a principal-agent framework, they are often seen as problematic in that they appear to lead to increased agency costs (even though they may help solve other problems). But considering them within a team production framework sheds light on how they may help to reduce transactions costs associated with team production.

John Armour, Henry Hansmann, and Reinier Kraakman (2009) identify five legal features that are characteristic of business corporations across most national jurisdictions: "legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership" (Armour et. al., 2009: 1).[4] In addition to these five, this article will also consider a sixth feature, "indefinite existence."

* Legal personality, or separate existence, or separate entity status for the corporation. Corporations (unlike individual proprietorships or common law partnerships), are legal entities, separate under the law from their managers, shareholders, creditors, employees, and even from individual board members. As such, they can purchase, own, and sell property, enter into contracts, and sue and be sued in the name of the corporation rather than in the name of any of its participants.[5] Separate entity status is the most important of the characteristics of corporations, because most of the other distinguishing attributes are a consequence of the fact that the corporation has a separate existence.

Separate existence of the corporation serves a number of important functions, from facilitating contracting among the participants in the corporation, to keeping corporate assets separate from the personal assets of the participants,[6] to permitting the business and assets of the corporation to continue, even as various participants come and go. Separate legal existence, however, is hard to explain under the standard agency theory account of corporate law, in which shareholders are viewed as principals in a complex set of interlocking contracts in which other key participants – especially directors, managers, and employees – are supposed to be pursuing the best interest of the shareholders. In fact, the earliest literature on the principal-agent theory of the firm (Jensen and Meckling, 1976) assumed away separate legal existence by postulating

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[4] In fact, Armour et. al. (2009: 2) assert that "a principal function of corporate law is to provide business enterprises with a legal form that possesses these five core attributes." The last of these attributes, "investor ownership" does not seem well-defined in the context of corporations, so this problem will be considered below.
[5] Armour et.al. (2009) define "legal personality" as organizational forms that share the "attributes of being capable of entering into contracts and owning its own property; capable of delegating authority to agents; and capable of suing and being sued in its own name." Yet it seems odd and imprecise to say that corporations "delegate authority to agents." Instead, the law, in creating the entities, delegates all authority to act and decide for corporations to their boards of directors.
[6] Hansmann and Kraakman (2000) have called this function "asset partitioning," which is a combination of limited liability and what I have elsewhere called "capital lock-in" (Blair, 2003).

that a firm (and a corporation in particular) is no more than a legal fiction that serves as a nexus of contracts. Subsequent corporate law scholarship adopting a principal-agent analysis has frequently denied that separate entity status is important.

Yet separate legal existence (entity status) precedes, and is more fundamental to the nature of the corporation, than even shareholders. A corporation must come into existence as a separate entity before it can issue and sell stock to shareholders. Moreover, corporations can exist without shareholders. The earliest corporations were eleemosynary institutions (such as churches, hospitals and universities), or civil institutions (such as townships and municipalities) that did not have shareholders. Modern non-profit corporations (which own a sizeable share of total wealth in the U.S.) also have no shareholders. While for-profit corporations have shareholders, those shareholders do not legally own the assets of the corporation, and they cannot compel a corporation to distribute its assets to shareholders. The exception is in corporations that have only a single shareholder, and even in this case, there are legal limits on how much of the assets the shareholder may take out.[7]

While separate entity status fits uncomfortably with shareholder-centric principal-agent theories of the firm, it serves a critical function in team production theories. The team production theory of corporate law emphasizes that all of the participants in a corporation are mutually interested in fostering the cooperation of, and protecting themselves from any dishonest tendencies of, all of the other participants. In this context, separate entity status serves a number of valuable purposes. It provides a mechanism by which the team assets used in production can all be owned by the same entity; it commits the assets to use by the team for team purposes because those assets are not owned directly by any of the team members; and it assures that no team members have the right to take the assets out of the corporation or expropriate them for personal use. This makes it easier for all of the participants to credibly commit to working toward a common goal. It may also be easier to elicit mutual cooperation by all of the participants if that goal is understood to be maximizing the total value generated by the enterprise, rather than the total share of value captured by one group of participants.

* Limited liability. The idea that shareholders do not have personal liability for debts of the corporation is hard to square with an assertion that shareholders are the "owners" of corporations. Ownership of property in every other context implies not only that the owner can possess the property, use it for his own purposes, or dispose of it, but also that the owner can be held liable for misuse of property that harms others. But limited liability for shareholders makes perfect sense if we understand the corporation as a separate legal entity that supports team production. If the entity is separate, then it follows more or less naturally that, while all of the participants can lose what they contributed to the entity (the creditors their loaned funds, the managers and employees their time and human capital, the suppliers their as yet unpaid-for

[7] See e.g., MBCA §6.40 (Imposing constraints on distributions to shareholders). Early legal rules governing the incorporation of businesses as corporations required that there be more than one shareholder. Cite. In corporations with a single shareholder, the primary purpose of corporate form is to enable the single investor/entrepreneur to separate out assets that are available to pay the personal creditors of the entrepreneur from those that are available to pay the creditors of the business. This situation could alternately be characterized as a solution to a specific type of "team production problem" between the entrepreneur and her business creditors, in which the commitment of assets by the entrepreneur to the separate legal entity which is carrying out the business helps to reassure business creditors that the entrepreneur will use business assets to repay the creditor before she takes out assets for herself.

supplies, the shareholders their initial capital investment), none can be held personally responsible for compensating any of the other participants, or third parties such as tort claimants, for losses that the corporation cannot pay. Limited liability for shareholders makes their contribution to the joint enterprise quite similar to the contribution of creditors, except in the order of priority in which they are paid in any final disposition or settlement.[8]

* Transferable shares. Because a corporation is a separate legal entity, shareholders have limited liability, and the contribution of shareholders qua shareholders is simply money, the identity of the shareholders may be a matter of complete indifference to the enterprise and to the other participants. The contribution (and associated claims) of shareholders can thus be divided up into completely fungible units, which can be parsed, or held in portfolios, or traded among various investors without having any direct impact on the enterprise or its other participants. This is one of the truly brilliant innovations of the corporate form of organizing businesses. Fungible shares separates the task of contributing capital from any other contribution that a specific investor might make, and assures that capital can be committed to the enterprise without requiring a commitment by any particular capital provider to continue to participate. The ability to "lock-in" the capital without locking in the capital provider makes it vastly easier for entrepreneurs to raise committed capital.

The ready transferability of shares is quite problematic, however, for a principal-agency theory of the corporation in which shareholders are supposed to be the "principals." Other scholars have observed and documented that shareholders are not all alike in terms of their goals for their investments, or their values or views about what the goals should be for the corporations in which they invest (Rose, 2010: 1370-1380). Moreover, as shareholdings turn over in any given corporation, the goals of shareholders will likely be in continuous flux. Numerous observers have commented on the fact that the share turnover rate of corporations listed on the major stock exchanges in the U.S. is very high (Strine, 2010: 10-12). Thus, any mandate or expectation that the corporation should be run solely in the interest of shareholders would be impossible to satisfy.

Multiple goals and frequent turnover among shareholders is less problematic under team production analysis, however. This approach starts from the premise that various team members will have multiple, sometimes competing goals that must be negotiated and balanced as team members work through what they are doing, how they will do it, and how any value created is going to be divided.[9] The most important constraint on how the proceeds of the enterprise are divided up is that each participant or team member must capture sufficient value to cause him to stay on the team and continue to contribute (Blair & Stout, 1999). This means that the team must

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[8] In bankruptcy settlements, however, it is commonly the case that shareholders recover some positive amount even if creditors have not recovered every dime of value that they are owed (Longhofer & Carlstrom, 1995). The frequency of this outcome is evidence that shareholders are not the only "residual claimant" in a corporation, and that other participants in the corporation are not fully protected by contract with the corporation. In many other contexts, too, events and actions that benefit shareholders may have a negative effect on other corporate participants. Klein and Zur (2011), for example, show that when a hedge fund activist takes an equity stake in a corporation, the share price of the target company goes up, but the firm's bondholders lose almost as much value as the shareholders gained.

[9] This same analysis would thus apply even if the only team members being considered were various shareholders (Bratton & Wachter, 2009-2010).

try to ensure that shareholders receive a satisfactory return on investment including adequate compensation for risk. But it notably does not mean that boards of directors or managers must try to "maximize share value," as is often asserted by advocates of shareholder primacy. Consistent with team production analysis, but contrary to principal-agent analysis and shareholder primacy, corporate law does not require that directors or managers must maximize share value.[10]

* Delegated management under a board structure. The role of the board of directors in corporations has been the subject of much debate (Blair and Stout, 2001). Under a shareholder-centric principal-agent analysis, it has been argued that control rights in corporations have been delegated to boards to take advantage of the benefits of specialization, with some corporate participants providing risk capital, while others provide management expertise (Jensen & Meckling, 1976; Easterbrook and Fischel, 1991; Meese, 2002). The same theorists who extoll the benefits of specialization also argue that the role of directors is to serve as faithful agents of shareholders in directing the firm in such a way as to maximize share value.

This latter assertion, however, is at odds with the legal description and duties of directors. Under corporate law, directors are not agents of any particular group of participants in the corporation (Clark, 1985: 56; N.Y. Sup., 1939,[11]). If directors were indeed legal agents of shareholders, then it would not be the case that ownership would be separated from control, because shareholders could dictate to their agents what they are supposed to do. Corporate law makes it clear, however, that directors are not agents of shareholders, nor of any other corporate participants. Directors acting as a body (and not individually) are authorized by the law to exercise "all corporate powers," and to manage or direct "the business and affairs of the corporation."[12] The board of directors is thus the human decision-maker and nerve center of the corporation. Corporate officers and managers are agents of the corporation (not of the shareholders), and are subject to the oversight of directors. But the board itself is empowered to act for the corporation without being subject to the oversight or direction of any of the other participants in the corporation. Moreover, corporate law holds that directors and officers have fiduciary duties to the corporation itself,[13] but it does not specify how the interests of the corporation are to be determined. Enriques et. al. argue that such duties are "most naturally

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[10] A narrow exception applies in what has been called the "Revlon" context. *Revlon, Inc*. v. *MacAndrews & Forbes Holdings*, Inc. Del. S.C. 506 A.2d 173 (1986). When, in the midst of a negotiation regarding the acquisition of a corporation by another corporation, it becomes inevitable that the target corporation will be acquired, at that point, the board of directors of the target firm must try to get the highest price they can get for the target company shares. But even in the opinion in *Revlon*, the court was clear that this is an exception, and that the duty "changes" once the Revlon conditions apply. In all other contexts, courts have repeatedly affirmed that directors may balance the interests of shareholders against the interests of other corporate participants. E.g., *Unocal Corp*. v. *Mesa Petroleum Co.* Del. S.C. 493 A.2d 946 (1986) (providing that directors may consider the "impact on 'constituencies' other than shareholders" in deciding how to respond to an unsolicited tender offer).

[11] In *New York Dock Co.* v. *McCollum*, 16 N.Y.S. 2d 844, 847 (N.Y. Sup. 1939) the court found that "a director of a corporation is not an agent either of the corporation or of its stockholders . . . . [Rather] his office is a creature of the law."

[12] MBCA Sec. 8.01(b).

[13] Enriques, et. al. observe that "the corporate law of many jurisdictions provides that directors owe their duty of loyalty to the company rather than to any of its constituencies, including its shareholders." Enriques, et. al.,(2009: 103). In the U.S., courts sometimes say that directors' fiduciary duties are owed to shareholders (cites), but more commonly say that the duties are owed to the corporation (cites), or to the corporation and its shareholders (cites).

understood as a command to maximize the net aggregate returns (pecuniary and non-pecuniary) of *all* corporate constituencies. . . ." (Enriques, 2009: 103).[14]

This legal description of board governance is completely consistent with the team production theory of corporate law. Under team production theory the participants in a corporate enterprise agree to yield ultimate decision-making authority to the board so that they can more easily overcome mutual shirking and rent-seeking problems. The internal hierarchy of the corporation, according to Blair and Stout (1999), must coordinate the activities of the team members, allocate the resulting production, and mediate disputes among team members over that allocation. "At the peak of this hierarchy sits a board of directors whose authority over the use of corporate assets is virtually absolute and whose independence from individual team members is protected by law" (Blair & Stout 1999: 753).

* Investor ownership. The idea that shareholders are the "owners" of corporations at first seems more consistent with a principal-agent interpretation of corporate law than it is with a team production interpretation. But Armour et. al. (2009: 14), who identify "investor ownership" as a distinguishing characteristic of the corporate form, have adopted a very narrow and specialized notion of "ownership." As they use the term, the statement that investors are the "owners" of corporations is intended to capture two ideas, that parties who contribute capital to the firm in the form of equity shares have the right to "control the firm," and that they also have the right to "receive the firm's net earnings."

These authors equate "controlling the firm," however, with the right to vote in elections for directors, and to vote on certain other corporate transactions. While shareholders typically do get these rights, these rights hardly constitute "control," given that normally it is only the board of directors who may nominate individuals for election to the board,[15] and only the board of directors that may plan and propose corporate transactions (such as a mergers) that require shareholder approval. In fact, one of the great puzzles of corporate law, if one starts from a principal-agent perspective, is why shareholders have the right to vote on so few things (Blair, 2003).

Likewise shareholders get the right to pro-rata shares of any distributions that the board of directors decides to pay out to shareholders, but this is hardly the same thing as having the right to a firm's net earnings. Corporate law makes it clear that shareholders only get what is paid out to them, and that the decision about when and what to pay out resides solely with directors. As long as the net earnings are retained in the firm, they do not belong to the shareholders. And, while it would be true in theory that shareholders would get the "residual

[14] Enriques, et. al. (2009) fret, however, that because courts cannot enforce a duty to maximize aggregate private welfare, "the injunction to boards to pursue their corporations' interests is less a species of equal sharing than, at best, a vague counsel of virtue, and, at worst, a smokescreen for board discretion."

[15] Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC in August of 2010 changed federal proxy rules to provide that, under certain conditions, shareholders may have their nominees for board elections placed on the company's proxy (Rule 14a-11; SEC Adopts New Measures to Facilitate Director Nominations by Shareholders, http://www.sec.gov/news/press/2010/2010-155.htm). To take advantage of this right, however, shareholders must hold at least 3% of the outstanding shares of the corporation and satisfy other requirements. Implementation of the new rule has been on hold since October of 2010 pending resolution of a legal challenge to the new rule by the U.S. Chamber of Commerce and the Business Roundtable (U.S. Securities and Exchange Commission, File No. S7-10-09, Oct. 4, 2010).

value" that is left after payment to all other corporate participants in a complete liquidation of the firm, it is notable that the "residual value" claim applies in practice only at the time when the corporation is being wound up and its existence coming to an end (and is often violated even then (Longhofer & Carlstrom, 1995)).

Armour et. al. note that the default rule for business corporations is that both voting rights, as well as the rights to receive dividends, are allocated in proportion to capital contributions by shareholders, taking this as evidence that "the law of business corporations is principally designed to facilitate the organization of investor-owned firms." Armour et. al., (2002: 14-16). But proportional allocation of voting right and distributions may simply be a product of the fact that the shares are designed to be fungible and transferable.[16] If shares have any voting rights or claims to distributions, those rights and claims must be allocated proportionately in order for the shares to be fungible.

If one starts with a team production framework, however, there is no particular need to identify one or another group of participants as "owners." Instead, all participants are seen to bring different contributions, and any or all may have some specific contractual rights. But the allocation of any surplus value is left to the board of directors, and the board itself retains all unallocated control rights. When the corporation is doing well, most of the firm's participants will also do well, and when times are not so good, many of the firm's participants will experience losses.

* Indefinite existence. In addition to the five distinguishing characteristics of business corporations identified by Armour et. al. (2009), another important feature is that corporations can continue to exist long after the initial organizers, directors, and investors are gone and have been replaced by others (Klein, et. al., 2010: 109). This feature has been called "indefinite existence" or "indefinite duration" (Klein, et. al., 2010: 109). It facilitates the accumulation of assets in a firm that are dedicated to the team enterprise, and is closely associated with a feature of corporate law that I have elsewhere called "capital lock-in" (Blair, 2003; Bank, 2006). Once shareholders have paid capital into a corporation to purchase shares, shareholders cannot compel the firm to buy back the shares or even to pay dividends, and neither can any of the creditors or heirs of the shareholders. The assets stay "locked in" the corporation until the board of directors decides to distribute them. While these legal rules are problematic from the perspective of a principal-agent model, they are easy to explain under a team production model of the firm because they protect all of the parties who make specific investments in the firm, making it possible for the corporation to commit both capital and the earnings from capital over time to the enterprise that the firm is undertaking, while encouraging similar commitments on the part of providers of human capital.

III. Cracks in the Dominance of Shareholder Primacy

Recent scholarship on corporate governance increasingly acknowledges problems with viewing corporate governance issues solely through the shareholder-centric principal-agent

[16] Only shares of the same class are expected to be fungible. Thus different classes of shares may get different voting rights that are not necessarily proportional to capital contribution.

model (Frey & Osterloh (2005); Daily et. al., 2003; Boatright, 2009; Sharfman & Toll, 2009) After early excitement about findings by Gompers, et. al. (2003), and Bebchuk, et. al. (2005) that suggested that superior stock market performance could be predicted in corporations by indices of the strength of shareholder rights in a firm (constructed by counting up the presence or absence of certain charter provisions), more recent work suggests that this relationship has not held up over time (Core, et. al., 2006; Bhagat & Bolton, 2007). While Gompers, et. al. (2003) found that corporations with weak shareholder rights had relatively poor stock price performance, and firms with strong shareholder rights had strong stock price performance, they found no evidence of correlation between weak shareholder rights and weak operating performance. By contrast, Core, et. al. (2006) and Bhagat & Bolton (2008) find the opposite, that firms with weak shareholder rights tend to have poor operating performance, but not poor stock price performance. Core, et. al. (2006) argue that their findings are consistent with the relationship between shareholder rights and stock price performance in the 1990s not being a causal relationship, with poor shareholder rights leading to poor performance, but resulting instead from some kind of anomaly of the 1990s. An important mechanism by which weak shareholder rights is thought by some to lead to weak corporate performance is that firms with weak shareholder rights are harder for outsiders to take over, and thus are less likely to be disciplined by the market for corporate control (Core, et. al.,2006). But Core, et. al. (2006) find that "weak governance firms are taken over at about the same rate as strong governance firms" (2006: 657) (these studies define "weak governance firms" as those with weak shareholder rights and strong protections for existing management).

In addition to studies by finance scholars that cast doubt on the hypothesized causal relationship between weak (strong) shareholder rights and weak (strong) performance, management and finance scholars have expressed concern that the empirical facts of how corporations are organized and governed do not fit the principal-agent model (Garvey & Swan, 1994; Daily, et. al., 2003), and note that most empirical studies based principal-agent models have had little or no ability to predict financial performance or other measures of performance consistently (Daily, et. al., 2003; Bhagat & Bolton, 2008).[17] Evidence is at best mixed on whether reforms based on enhancing shareholder power, or making boards of directors more independent, succeed in enhancing corporate performance (Bhagat & Bolton, 2008; Core, et. al., 2006; Bhagat & Black, 2002; Daily, et. al., 2003; Kaufman & Englander, 2005; Stout, 2007; Arlen & Talley, 2003-2004). Meanwhile, scholars have found no systematic evidence of a significant negative effect on the performance of share prices in firms where employees have explicit influence on the boards of directors, through co-determination (Aguilera and Jackson, 2010: 526).

While it is not clear that shareholder primacy reforms enhance corporate performance, an exclusive focus on share value may actually do harm to corporate performance. Legal scholars have noted lately that that shareholders do not all have the same interests, and that this raises challenges for simple principal-agent models of corporate governance (Rose, 2010). And finance and legal scholars have begun examining the implications of the fact that shareholders

[17] Although Bhagat & Bolton (2008), like Core, et. al. (2006) do find a positive correlation between measures of strong shareholder rights and operating performance, they find no relationship between the same measures of shareholder rights and stock market performance. This is the reverse of what Gompers, et. al. (2003), and Bebchuk, et. al. (2005) found. Notably, none of these studies include data on the performance of firms in the years leading up to and including the financial market crisis of 2008-2009.

who hedge away their financial interest in a corporation can have interests that are diametrically opposed to all of the other participants in the corporation, including the other shareholders (Partnoy, 2000; Hu and Black, 2006, 2007). Financial derivatives now make it possible for all of the claims and rights associated with share ownership to be broken apart and traded separately (Partnoy, 2000), which raises numerous questions about what, exactly, is in the interest of any given shareholder, let alone shareholders as a group.

Moreover, individuals and financial firms that hold or acquire significant holdings in a corporation may encourage the firm to engage in a variety of speculative activities that are not aligned with society's best interests, as became painfully apparent during the widespread series of financial crises that began in 2007. Klein and Zur (2011), for example, find that when hedge funds acquire a significant stake in a target corporation, the stock price of the target firm's shares increases, but the firm's bonds lose almost as much value as the shareholders gain. In fact, Bratton & Wachter (2010: 717 -) argue that an analysis of the tendency of shareholders to encourage managers to take excessive risks (thereby imposing costs on other corporate stakeholders as well as the society at large) would likely show that the firms that were most responsive to pressures from the market for increases in share prices were the firms that took on excessive leverage and consequently fell the furthest during the crisis. Countrywide Financial Corp., they note "was [a] clear market favorite [among banks] at least until mid-2007," but quickly turned into "one of the clear villains in the story" (Bratton & Wachter, 2010:718; Gelter, ____). Similarly, the *New York Times* has documented the way that Washington Mutual Inc. ("WaMu") internally tracked and documented the extraordinary amount of risk it was undertaking as it continued to purchase mortgages that had little or no documentation behind them well into 2008, it did not abjure this business because to do so "would have devastated profits" in the short run (Norris, 2011). WaMu was another poster child of the failures in the financial markets. Both Countrywide and WaMu collapsed in 2008 and had to be taken over by other banks, at considerable cost to taxpayers.

In the wake of the corporate scandals of the early 2000s, and at an accelerating pace in the last few years, prominent shareholder rights advocates have conceded that it may not always be in society's best interests for corporations to be run solely to maximize share value. Michael Jensen, for example, now argues that corporate managers should try to maximize "the market values of all other financial claims including debt, preferred stock, and warrants." (Jensen, 2001) Similarly, Lucian Bebchuk and Holger Spamann (2010) now admit that maximizing value for shareholders can impose costs on other participants in the firms, and on society generally. In particular, they now propose that bankers should be compensated in ways that encourage them to take into account risks on "preferred shareholders, bondholders, depositors, and taxpayers," as well as on shareholders, by, for example, tying compensation not just to the performance of common shares, but to a "broader basket of securities." (Bebchuk & Spamann, 2010, p. 6). Although Bebchuk and Spamann (2010) apply their reasoning solely to banks, the same logic applies to all corporate enterprises.[18] More generally, some scholars have proposed alternative models for understanding corporate governance in which boards and managers are said to be

[18] Some might object that this argument only applies to banks because a bank's downside risk is borne in part by the government, but Bebchuk and Spamann (2010) specifically say that they believe their argument would hold even without deposit insurance. " Even if they [depositors] were not protected by insurance, the vast majority of small depositors would have neither the incentives nor the resources to monitor the bank's behavior" they observe. (Bebchuk and Spamann, 2010: 11)

agents for multiple principals (Rose, 2010, 1375-1377), while others have begun considering the agency costs associated with shareholder empowerment (Bratton & Wachter, 2010).

None of these problems, or their proposed solutions, are surprising under a team production analysis. Team production theory would predict that corporate governance reforms designed to tie the incentives of boards and managers to those of shareholders, or to give shareholders more access to or influence over directors or managers, will not necessarily improve the overall performance of the firms. Team production theory accommodates the fact that shareholders are not monolithic, and that the task of managing and governing a corporation requires a balancing of interests, rather than a commitment to benefit one set of interests, even at the expense of the others.

Although few of leading law and economics scholars have explicitly adopted the team production framework to address the problems with shareholder primacy, once it is conceded that it may not be in society's interests for corporate managers and directors to focus exclusively on "maximizing share value", or, indeed, that a mandate to maximize share value even has the same meaning for all shareholders, theories about the role of corporate directors in the face of competing interests among shareholders and other stakeholders take on most of the important features of the team production model as laid out by Blair & Stout (1999).

These cracks in the intellectual dominance of the shareholder-centric principal-agent approach to analyzing corporate law and corporate governance come even as corporate governance policy itself moves in various ways toward increasing shareholder power in corporations. In the early 1990s, the SEC relaxed rules that restricted institutional shareholders from exchanging information with each other about corporate governance matters in portfolio companies. This made it easier for institutional shareholders to freely communicate with each other and with other shareholders without triggering filing requirements with the SEC (Blair, 1995: 71; Monks & Minow, 1995: 154). Similarly, the emergence of proxy advisory services have offered a market solution to the collective action problem that inhibited shareholder action in the past (GAO, 2007). Rose (2010) has developed evidence that institutional shareholders now have some significant influence on corporate policies (Rose, 2010). In particular, institutional investors have become increasingly active in pressuring portfolio companies to eliminate poison pills and staggered boards, to disclose executive compensation arrangements and to give shareholders a chance to approve or disapprove of them, and to change voting rules so that directors can only be elected by the affirmative vote of a majority of outstanding shares. In the wake of the corporate scandals of 2001-2002, Congress passed the Sarbanes-Oxley Act that imposed new requirements for director independence at publicly-traded corporations,

The U.S. Congress was apparently also persuaded that shareholders should be given more clout in corporate governance arrangements, rather than less, and enshrined in the Dodd-Frank Wall Street Reform and Consumer Protection Act that the SEC should rewrite its rules to assure that corporations must give shareholders the right to approve compensation packages for executives, and to give shareholders easier access to proxies for nominating directors. SEC acted on this during the summer of 2010, but in September of 2010, the Business Roundtable and the U.S. Chamber of Commerce initiated legal action to prevent the new rules from being implemented (U.S. Securities and Exchange Commission, File No. S7-10-09, Oct. 4, 2010). If a widespread corporate commitment to maximizing share value, despite the risks and costs imposed on others, was one of the factors that contributed to the financial bubble and subsequent

collapse, these regulatory changes are going in the wrong direction (Blair, 2010; Bratton & Wachter, 2010).

Conclusion:

More than a decade ago, Professors Margaret Blair and Lynn Stout developed an alternative framework for understanding corporate law that was well-grounded in economic theory, but that did not reify "share value" as the most important goal of corporations. Their framework recognized and accommodated interests of other corporate participants as well as shareholders. Although the team production framework has been criticized (from both the right and the left) on the grounds that it does not provide clear directions for boards of directors (Meese, 2002; Millon, 2000), there is growing reason to believe that leaving the direction of corporations to the business judgment of directors (while bidding them to be responsible corporate citizens and to pay attention to the larger social costs and benefits of corporate action) may not be worse, and may be better in many instances than instructing them and incentivizing them to do whatever it takes to make share prices higher. As the weaknesses in the shareholder primacy view of corporate governance have become increasingly apparent, this alternative, the "team production theory," may be seen as increasingly relevant.

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