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A Team Production Theory of Corporate Law

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ARTICLE

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Introduction

WHO owns a corporation? Most economists and legal scholars today seem inclined to answer: Its shareholders do. Contemporary discussions of corporate governance have come to be dominated by the view that public corporations are little more than bundles of assets collectively owned by shareholders (principals) who hire directors and officers (agents) to manage those assets on their behalf.[1] This principal-agent model, in turn, has given rise to two recurring themes in the literature: First, that the central economic problem addressed by corporation law is reducing "agency costs" by keeping directors and managers faithful to shareholders' in-

[1] The literature employing the principal-agent approach is too voluminous to cite in its entirety. However, in economics the principal-agent model can be traced to a number of articles. See, e.g., Eugene F. Fama, Agency Problems and the Theory of the Firm, 88 J. Pol. Econ. 288 (1980); Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, 26 J.L. & Econ. 301 (1983); Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976). Examples of legal scholarship viewing the corporation from this perspective include Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law (1991) [hereinafter Easterbrook & Fischel, Economic Structure]; Foundations of Corporate Law (Roberta Romano ed., 1993); Lucian Arye Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 Harv. L. Rev. 1435 (1992); Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520 (1990); Victor Brudney, Corporate Governance, Agency Costs, and the Rhetoric of Contract, 85 Colum. L. Rev. 1403 (1985); William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663 (1974); Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981) [hereinafter Easterbrook & Fischel, Responding to Tender Offers]; Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 Stan. L. Rev. 863 (1991); Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110 (1965); Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251 (1977).

terests; and second, that the primary goal of the public corporation is—or ought to be—maximizing shareholders' wealth.

In this Article we take issue with both the prevailing principal-agent model of the public corporation and the shareholder wealth maximization goal that underlies it. Because corporations are fictional entities that can only act through human agents, problems of agent fealty are frequently encountered by those who study and practice corporate law. Yet the public corporation is hardly unique in its use of agents. Other organizational forms, including partnerships, proprietorships, privately-held corporations, and limited liability companies, also routinely do business through hired managers and employees. Thus, while the principal-agent problem may be important in understanding the business *firm*, we question whether it necessarily provides special insight into the theory of the public *corporation*. We explore an alternative approach that we believe may go much further in explaining both the distinctive legal doctrines that apply to public corporations and the unique role these business entities have come to play in American economic life: the *team production* approach.

In the economic literature, team production problems are said to arise in situations where a productive activity requires the combined investment and coordinated effort of two or more individuals or groups.[2] If the team members' investments are firm-specific (that is, difficult to recover once committed to the project), and if output from the enterprise is nonseparable (meaning that it is difficult to attribute any particular portion of the joint output to any particular member's contribution), serious problems can arise in determining how any economic surpluses generated by team production—any "rents"—should be divided. Ex ante sharing rules invite shirking,[3] while ex post attempts to divvy up rewards create incentives for opportunistic rent-seeking[4] that can erode and even destroy the economic gains that flow from team production. Yet

[2] See, e.g., sources cited infra notes 33, 40 (discussing team production).

[3] "Shirking" occurs when individuals fail to make optimum efforts to ensure a joint project's success, instead free-riding on others' efforts.

[4] "Rent-seeking" refers to situations where individuals expend time, money, and other resources competing for a fixed amount of wealth, in effect squabbling with each other over the size of their individual pieces of a fixed group pie. Because rent-seeking itself is costly, the net result is to reduce total wealth available for distribution.

trying to prevent shirking and rent-seeking by defining individual team members' duties and rewards through explicit contracts can be impossibly difficult, especially when the team production process is complex, continuous, or uncertain.

While team production problems are less well studied than principal-agent problems, we believe the former may represent a more appropriate basis for understanding the unique economic and legal functions served by the public corporation. Our analysis rests on the observation—generally accepted even by corporate scholars who adhere to the principal-agent model—that shareholders are not the only group that may provide specialized inputs into corporate production.[5] Executives, rank-and-file employees, and even creditors or the local community may also make essential contributions and have an interest in an enterprise's success. And in circumstances where it is impossible to draft explicit contracts that deter shirking and rent-seeking among these various corporate "team members" by preallocating rewards and responsibilities, we suggest that the problem may be better left to an institutional substitute for explicit contracts: the law of public corporations.

We argue that public corporation law can offer a second-best solution[6] to team production problems because it allows rational individuals who hope to profit from team production to overcome shirking and rent-seeking by opting into an internal governance structure we call the "mediating hierarchy." In essence, the mediating hierarchy solution requires team members to give up important rights (including property rights over the team's joint output and over team inputs such as financial capital and firm-specific human capital) to a legal entity created by the act of incorporation. In other words, corporate assets belong not to shareholders but to

[5] See, e.g., Easterbrook & Fischel, The Economic Structure of Corporate Law, supra note 1, at 35-39 (noting that other corporate stakeholders make firm-specific investments, while defending shareholder wealth maximization on the grounds that nonshareholder groups can protect themselves adequately through contract); Jonathan R. Macey, Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes, 1989 Duke L.J. 173, 188-92 (same). See generally infra note 61 and accompanying text (discussing how shareholders and stakeholders invest firm-specific resources).

[6] "Second-best" solutions in economics represent the best outcome that can be achieved, given that some of the conditions necessary for a first-best solution are violated. See, e.g., Kelvin Lancaster & Richard G. Lipsey, The General Theory of the Second Best, *in* Trade, Markets and Welfare 193, 193-220 (Kelvin Lancaster ed., 1996).

the corporation itself. Within the corporation, control over those assets is exercised by an internal hierarchy whose job is to 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—as we demonstrate later in this Article—is protected by law.[7]

The team production model of the public corporation both highlights and explains the essential economic function served by that otherwise puzzling institution, the board of directors. The notion that responsibility for governing a publicly held corporation ultimately rests in the hands of its directors is a defining feature of American corporate law;[8] indeed, in a sense, an independent board is what makes a public corporation a public corporation.[9] Yet

[7] Once this internal governance structure is in place, courts give it wide discretion and resist becoming involved in disputes over how the hierarchy uses its inputs and allocates its outputs. Thus, one of the most important things that distinguishes transactions that take place among "team members" within a corporation from contracts and other transactions that take place among individuals in markets is that the courts generally refuse to intervene in disputes involving the former. See infra Section II.C (discussing when the law does and does not permit judges to intervene in corporate decisionmaking).

[8] See, e.g., Del. Code Ann. tit. 8, § 141 (1974 & Supp. 1996). For much of the twe n-tieth-century, both common law and state statutes required that boards of directors manage publicly held corporations. See Jeffrey N. Gordon, Shareholder Initiative and Delegation: A Social Choice and Game Theoretic Approach to Corporate Law, 60 Cincinnati L. Rev. 347, 348-49 & n.7 (1991). During the 1960s and 1970s, some states amended their codes to permit corporations to include contrary provisions in their charters. However, as a practical matter such provisions seem "non-existent" among public corporations. Id. at 349 & n.7. In contrast, most states allow shareholders in privately held firms to manage their firms directly rather than through an elected board. See, e.g., Del. Code Ann. tit. 8, §§ 350, 351 (1974) (describing special rules permitting shareholders in closely held firms to dispense with a board of directors). Moreover, private firms frequently adopt these and other measures to ensure shareholders' direct control. See Robert Charles Clark, Corporate Law 781-82 (1986) (describing how shareholders in private corporations adopt arrangements restricting directors' discretion in ways that are impermissible in publicly held firms).

[9] An independent board is one of the most important characteristics distinguishing public corporations from other forms of enterprise. Limited partnerships, limited liability companies ("LLCs"), and closely held corporations all limit investors' liability without requiring them to do business through a board; partnerships, LLCs and private firms provide vehicles for collective investment, sometimes with free transferability of shares; private corporations and some limited partnerships enjoy perpetual existence; and virtually all forms of enterprise permit their owners to delegate the

while the board of directors is central to public corporation law, it raises troubling questions under the principal-agent model. Shareholders' rights and powers over directors in publicly held companies are remarkably limited both in theory and in practice, and as a result directors of public firms enjoy an extraordinary degree of discretion to pursue other agendas and to favor other constituencies, especially management,[10] at shareholders' expense. This reality raises a difficult question that has preoccupied corporate scholarship since at least the days of Adolf Berle and Gardiner Means:[11] How can widely dispersed shareholders in public corporations make sure directors use their authority to further shareholders' interests?[12]

Commentators generally have offered two types of responses to this perceived problem. The first response is that, even though the legal constraints on directors are weak, market constraints—product markets, capital markets, the market for corporate control, and so forth—keep directors focused on maximizing profits and share value.[13] The second response has been to criticize director discretion as inefficient, and to attribute the legal rules granting directors so much discretion to a legislative "race to the bottom" in which states, competing for corporate charters, have given away

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day-to-day management of the firm to hired professionals. In contrast, governance by a board of directors, many of whose members are drawn from outside the firm, seems unique to the publicly held company.

A second singular characteristic of publicly held firms is the existence of a highly-developed and liquid secondary stock market where investors can sell their shares. See infra text accompanying notes 193-94 (discussing how evolution of the public corporation might reflect liquidity rather than team production advantages).

[10] Commentators sometimes use the word "management" to refer indistinguishably to both the corporation's board of directors and its top officers. This practice probably reflects the fact that it is common for the boards of public corporations to include both "outside" directors who have no other relationship with the firm and "inside" directors who are also employed as officers. For purposes of our discussion, however, it is essential to retain the formal distinction between the two roles.

[11] Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property (1932).

[12] An extensive literature accordingly questions the efficiency of public corporations in which the role of "owner" is separated from "control." See, e.g., sources cited supra note 1.

[13] See, e.g., Foundations of Corporate Law, supra note 1; Winter, supra note 1; Fama, supra note 1; Fama & Jensen, supra note 1; Jensen & Meckling, supra note 1; Manne, supra note 1. See generally Roberta Romano, The State Competition Debate in Corporate Law, 8 Cardozo L. Rev. 709 (1987) (discussing how competition among states for corporate tax revenues leads to limited legal restrictions upon corporate behavior).

the store to corporate directors and executives.[14] It should be noted, however, that both of these responses presume that directors should serve shareholders exclusively. Advocates of both views tend to regard changes in the law that weaken shareholders' control over directors (for example, antitakeover legislation or corporate constituency statutes) as bad public policy. Thus both views reflect a "shareholder primacy norm" that has been prominent in the legal and the economic literature for decades, but has become especially dominant in the last twenty years.[15]

The team production model provides an alternative answer to the question of why corporate law grants directors of public corporations so much leeway. In particular, it suggests that the legal requirement that public corporations be managed under the supervision of a board of directors has evolved not to reduce agency costs—indeed, such a requirement may exacerbate them—but to encourage the firm-specific investment essential to certain forms of team production. In other words, boards exist not to protect shareholders *per se*, but to protect the enterprise-specific investments of *all* the members of the corporate "team," including shareholders, managers, rank and file employees, and possibly other groups, such as creditors. Because this view challenges the shareholder primacy norm that has come to dominate the theoretical literature, our analysis appears to parallel many of the arguments raised in recent years by the "communitarian" or "progressive" school of corporate scholars who believe that corporate law ought to require directors to serve not only the shareholders' interests, but also those of employees, consumers, creditors, and other corporate "stakeholders."[16]

[14] See, e.g., Bebchuk, supra note 1; Brudney, supra note 1; Cary, supra note 1.

[15] See, e.g., Bernard Black & Reinier Kraakman, A Self-Enforcing Model of Corporate Law, 109 Harv. L. Rev. 1911, 1921 (1996) ("The efficiency goal of maximizing the company's value to investors [is] the principal function of corporate law."); Deborah A. DeMott, Beyond Metaphor: An Analysis of Fiduciary Obligation, 1988 Duke L.J. 879, 917 (assuming that interests of a corporation are generally identical to interests of its shareholders); Roberta Romano, Corporate Law and Corporate Governance 2-3 (1996) (unpublished manuscript, on file with the Virginia Law Review Association) ("[T]he board represents the interests of shareholders and not other constituents."); D. Gordon Smith, The Shareholder Primacy Norm, 23 J. Corp. L. 277 (1998); infra text accompanying notes 198-206 (discussing reasons why the shareholder primacy norm became so pervasive in the last two decades).

[16] See, e.g., Lawrence E. Mitchell, A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes, 70 Tex. L. Rev. 579, 630-43 (1992) (arguing

We believe, however, that our mediating hierarchy approach, which views public corporation law as a mechanism for filling in the gaps where team members have found explicit contracting difficult or impossible, is consistent with the "nexus of contracts" approach to understanding corporate law.[17] Moreover, our approach carries very different policy implications: Where progressives have argued that corporate law ought to be reformed to make directors more accountable to stakeholders, the mediating hierarchy approach suggests that directors should not be under direct control of either shareholders *or* other stakeholders.

Thus we argue that the mediating hierarchy interpretation of corporations is more consistent with the way a corporation actually works than are prominent contractarian interpretations of corporate law that focus on the principal-agent problem. This is because the modern tendency to think of shareholders as corporate "owners" and directors as their "agents" glosses over several key legal doc-

that courts should modify corporate law to grant stakeholders standing to sue directors when the former are harmed by corporate action); Marleen A. O'Connor, The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation, 78 Cornell L. Rev. 899, 936-65 (1993) (arguing that corporate law should be changed to encourage employee representation on the board and standing to sue); see also Daniel J.H. Greenwood, Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited, 69 S. Cal. L. Rev. 1021, 1023 (1996) ("[A]ll but the communitarians agree that virtually the sole task of corporate law is to ensure that managers act as agents for the shareholder owners."); cf. John C. Coffee, Jr., Unstable Coalitions: Corporate Governance As a Multi-Player Game, 78 Geo. L.J. 1495 (1990) (discussing role of stakeholders in firm); David Millon, Theories of the Corporation, 1990 Duke L.J. 201, 261-62 (praising case law that reaffirms directors' discretion to consider nonshareholder interests). See generally Progressive Corporate Law (Lawrence E. Mitchell ed., 1995) (surveying recent nontraditional approaches to corporate legal scholarship).

[17] The "nexus of contracts" view of the firm holds that relationships in the firm should be understood as an intertwined set of relationships between parties who agree to work with each other in pursuit of mutual benefit, even though not all the relationships that comprise a firm are necessarily spelled out in complete "contracts." As some scholars have pointed out, this notion of contract is so broad as to include virtually all voluntary social arrangements. See, e.g., Robert C. Clark, Agency Costs versus Fiduciary Duties, *in* Principals and Agents: The Structure of Business 55 (John W. Pratt & Richard J. Zeckhauser eds., 1985). It might perhaps be more informative to think of corporations, and hierarchical governance structures within corporations, as institutional substitutes for contracts, just as property rights are an institutional substitute and necessary precondition for contracts. Nevertheless, we locate the mediating hierarchy model of the public corporation within the nexus of contracts tradition because in the model, team members voluntarily choose to submit themselves to the hierarchy as an efficient arrangement that furthers their own self-interests.

trines distinguishing public corporations from other business forms that are difficult to reconcile with the principal-agent approach. These fundamental and otherwise puzzling characteristics of public corporation law can be explained as a response to the team production problem. In particular, the "mediating hierarchy" created when a corporation is formed has the purpose and effect of insulating corporate directors from the direct command and control of *any* of the groups that comprise the corporate team, including its shareholders. While this legal structure may increase agency costs, it may also provide an efficient (albeit second-best) solution to the contracting problems that arise in team production.

Our argument is structured as follows. Part I of the Article reviews the standard economic theory of the firm and describes how conventional analysis of corporations tends to focus on two approaches: *principal-agent analysis*, which focuses on the difficulties of drafting explicit contracts that keep agents faithful; and *property rights analysis*, which examines how property rights can sometimes overcome contracting problems by giving ultimate control rights to one party to the contract. After discussing why each may be of limited use in understanding the public corporation, Part I turns to a third (and, we believe, more promising) approach: *team production analysis.* Part I introduces the team production problem and explains why it may do a better job of mirroring the fundamental economic problem underlying public corporations than does the principal-agent approach. It then reviews potential solutions to the team production problem, such as granting property rights to team members, and concludes that these solutions may not work well in the corporate context. Instead, Part I explores an alternative solution—the mediating hierarchy—in which team members address the contracting problems inherent in team production by voluntarily relinquishing important control rights over firm-specific inputs and over outputs to a neutral decisionmaker who is not herself a member of the team. Part I concludes by examining how the mediating hierarchy solution is reflected in the structure of the modern public corporation, as well as addressing briefly some caveats to the team production approach.

Part II reviews the basic structure of corporation law to assess its consistency with the mediating hierarchy approach, and finds that analyzing corporations as mediating hierarchies provides a powerful theoretical explanation for several important legal rules that distinguish public corporations from other business forms. In particular, Part II discusses how the mediating hierarchy analysis explains: (1) Why the law views directors of public corporations more as trustees than as agents, effectively insulating them from shareholders' direct command and control; (2) the purpose of corporate personality and the derivative suit procedure; (3) the basic structure of the rules of fiduciary duty, including the narrow requirements of the duty of loyalty and the "business judgment rule" that insulates directors from most claims of breach of the duty of care, even when they deliberately sacrifice shareholders' interests to serve other constituencies or adopt business strategies that indirectly benefit themselves; and (4) why shareholders' voting rights are so limited in both theory and practice. Part II also explores how the mediating hierarchy solution deals with the problem of getting directors to serve the firm's interests.

Part III concludes by considering some preliminary lessons that can be drawn from analyzing the corporation as a solution to the team production problem. First, the team production approach may help explain why so many large enterprises are organized as publicly-traded corporations, rather than as partnerships, limited liability corporations, closely held companies, or other business forms that give investors tighter control. Specifically, the fact that the public companies are so dominant in our economy may be evidence that the contracting problems in team production are pervasive and costly (indeed, perhaps more costly than agency problems, which can be solved with alternative organizational forms). Second, team production theory, by focusing on the essential nature of the public corporation, suggests a promising direction for future scholarship in corporate law, namely, the political contexts in which corporations operate and the pressures that affect the decisionmaking process within corporations. Finally, the team production approach suggests a way to understand both the rise of the shareholder primacy norm in legal and popular debates about corporate governance and the growing clout that shareholders appear to have enjoyed lately in boardrooms.[18] The mediating hierarchy model

[18] See infra note 200 and accompanying text (discussing the recent apparent rise in shareholder power).

suggests that these changes result not from shareholders' moral or legal claims as "owners," but instead from broad shifts in the underlying economy and shifts in the relative political clout among members of the corporate "team." Such changes have given shareholders greater economic and political bargaining power relative to other stakeholders. Those underlying economic and political factors may well shift back again. Thus we applaud the fact that—despite the growing popularity of shareholder primacy rhetoric among academics and commentators—corporate law itself has so far rejected the shareholder primacy norm and declined to give shareholders tighter legal controls over directors. Far from raising a problem, this arrangement may be an ingenious, if second-best, solution to the contracting problems inherent in team production.

I. Economic Theories of the Corporation

One of the central questions in economic theory is: Why do firms exist? In other words, why organize work through hierarchical governance structures rather than through a series of market transactions? In the wake of Ronald Coase's seminal piece on the nature of the firm,[19] the literature on this question has developed along three main paths, each of which focuses on a different aspect of organizing productive activities. The first path explores contracting problems that arise when one actor hires another to act on

[19] See generally R.H. Coase, The Nature of the Firm (1937), *reprinted in* The Nature of the Firm: Origins, Evolution, and Development 18, 20 (Oliver E. Williamson & Sidney G. Winter eds., 1991) (suggesting that the important distinction is that "coordination is the work of the price mechanism in one case and of the entrepreneur in another"). Coase answered that a key feature of production in a firm is a "hierarchical" structure under which an entrepreneur who needs to acquire materials and services retains the right to direct the exact details of what and how products or services are delivered. A firm, therefore, consists of the systems of relationships which come into existence "[w]hen the direction of resources . . . becomes dependent on the buyer." Id. at 21. Firms emerge, Coase speculated, when it would be too costly and complicated to write contracts that give the buyer of the product or services the necessary degree of control.

Coase's analysis focuses on why entrepreneurial firms exist. We argue, however, that Coase's entrepreneur could solve her problem (the need to direct or control the product or service she is buying) using separate employment contracts between the entrepreneur and each employee. See infra text accompanying notes 59-60. Hence Coase's theory of the "firm" does not tell us why "corporations" are needed.

her behalf (the *principal-agent* problem). The second path examines problems associated with coordinating productive activities where it is too costly to write and enforce complete contracts, focusing especially on the role played by property rights as a solution for closing contractual gaps (the *property rights* approach). The third path considers the role hierarchy may play in policing against shirking problems that may arise in coordinating team production (the *team production* approach).

The existing law and economics literature heavily emphasizes the first two tracks, and indeed these ways of thinking about organizing production have provided valuable insights into the internal workings of firms. We believe, however, that when applied to public corporations, the principal-agent and property rights approaches are incomplete in critical ways. Thus the hitherto neglected team production approach can shed much needed light on both the fundamental economic nature of modern public corporations and the governance problems likely to arise in them. In particular, we outline how a theory of the public corporation as a solution to team production problems can explain key aspects of corporate law that scholars who favor the principal-agent and property rights approaches have found troubling. Before doing so, however, we briefly outline the prevailing principal-agent and property rights theories and demonstrate how these theories have contributed to the rise of a model of the corporation we call the "grand-design principal-agent" model.

A. Conventional Economic Analyses of the Firm

1. Principal-Agent Analysis

Principal-agent analysis deals with bilateral relationships of a particular kind: Typically, a "principal" who wants to accomplish some project she cannot do by herself hires an "agent" to do that project on her behalf. Agency relationships of this sort can pose efficiency problems if the principal cannot monitor the agent easily or well (as when the principal cannot accurately judge the quality of the agent's work) or when there is a significant component of chance in the link between what the agent does and how well the project turns out.[20] The problem, then, is how the principal can write a contract that motivates the agent to do his best to accomplish the principal's goals.

Although principal-agent analysis has been very useful in analyzing certain kinds of contractual relationships, it ignores several problems we think are often important to production within corporations. Principal-agent analysis generally assumes that the problem of interest is getting the agent to do what the principal wants. But the mathematical models used to study this problem typically do not address the opposite possibility—that the agent might have trouble getting the principal to perform her end of the deal.[21] Nor do they address situations in which part of the agent's job is to figure out what needs to be done (a situation we suspect is the norm rather than the exception in most public corporations). A related point is that the principal-agent model assumes that it is clear who the principal is, and who the agent is in the particular relationship or transaction under study. Yet many of the most important relationships inside corporations may be more ambiguous, in the sense that both parties may be contributing productive inputs and neither may have authority over the other. In fact, as we argue below,[22] this fundamental ambiguity underlies the basic structure of corporate law and provides the foundation for a more useful theory of public corporations.

2. Property Rights Analysis

A second interesting organizational problem arises when parties deal with each other over the course of a long-term productive relationship. Writing "complete" contracts that explicitly provide for all contingencies can often be costly or even impossible. Hence, economic and legal theorists have shifted their attention in recent

[20] As an example, consider the problems faced by a homeowner who hires a real estate agent to sell her home. It may be difficult for the homeowner to determine whether the agent is truly using his best efforts to market the house and also difficult to determine whether, if the house sells or does not sell, the agent is responsible.

[21] See, e.g., Paul Milgrom & John Roberts, Economics, Organization & Management 214-39 (1992) (devoting more than 25 pages to developing incentive contracting and other solutions to standard principal-agent problems, with no mention of the problem of getting the agent to perform).

[22] See infra Section I.B (discussing team production theory of corporations).

years to the study of "incomplete" contracts, and particularly to how parties in a working relationship can fill in the gaps in their understandings about who does what and who gets what in the course of a long-term productive relationship.[23] One mechanism that has been identified is assigning property rights to one of the parties to the contract that give that party a residual right of control over the assets used in the joint enterprise.

Building on this idea, some economists define the firm as a bundle of assets under common ownership (and therefore, common control).[24] When applied to public corporations, this way of thinking about firms sets up a sharp dichotomy between the "owners" of a firm—generally presumed to be the shareholders—and all other input providers, who are "hired." In this view, the degree of control and the share of joint output granted to contributors of hired inputs is understood to be clearly delineated ex ante by explicit contracts, while the "owner" is understood to retain all residual rights of control and to receive all the residual output after contractual obligations have been met.

The property rights view of the firm provides a powerful insight and may be a reasonable description of the way many proprietorships, partnerships, and closely held firms are organized. But it is not a theory of corporations: Corporate law is clearly not needed to achieve common ownership of assets. More importantly, the property rights view seriously misstates the nature of shareholders' interest in public corporations. If "control" is the economically important feature of "ownership," then to build a theory of corporations on the premise that ownership (and, hence, control) lies with shareholders grossly mischaracterizes the legal realities of most public corpora-

[23] Oliver Hart and various co-authors first analyzed the problem raised by contractual incompleteness and linked it to the theory of property rights and of the firm. See infra note 24; Oliver D. Hart, Incomplete Contracts and the Theory of the Firm, 4 J.L. Econ. & Org. 119; Alan Schwartz, Legal Contract Theories and Incomplete Contracts, *in* Contract Economics 76, 76-108 (Lars Werin & Hans Wijkander eds., 1992).

[24] See, e.g., Sanford J. Grossman & Oliver D. Hart, The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration, 94 J. Pol. Econ. 691, 693 (1986) (defining a firm as "those assets that it owns or over which it has control"); Oliver Hart, An Economist's Perspective on the Theory of the Firm, 89 Colum. L. Rev. 1757, 1766 (1989) (identifying a firm "with all the nonhuman assets that belong to it, assets that the firm's owners possess by virtue of being owners of the firm"); Oliver Hart & John Moore, Property Rights and the Nature of the Firm, 98 J. Pol. Econ. 1119, 1120 ("We identify a firm with the assets it possesses.").

tions.[25] Viewing the firm as a bundle of assets owned by shareholders also seems odd once we recognize that one of the key assets a corporation uses in production is "intellectual capital"—that is, the knowledge and experience residing in the minds of its employees, rather than the hands of its shareholders.[26]

3. Combining the Principal-Agent and Property Rights Approaches: A Theory of Hierarchy (But Not of Public Corporations)

In introducing the principal-agent and property rights approaches to the theory of the firm, we have tried to suggest some concerns that caution against relying upon them as foundations for a theory of public corporations. Nevertheless, these models have been used, sometimes explicitly and sometimes implicitly, to bolster a conventional view of the corporation that looks something like the model depicted in Figure 1.

[25] See infra Sections II.C, II.D (discussing legal and practical obstacles to shareholder control of corporate assets). To economists, a defining characteristic of ownership is that it gives the owner the residual right of control. See, e.g., Grossman & Hart, supra note 24, at 693-94 ("[W]e do not distinguish between ownership and control and virtually define ownership as the power to exercise control."); Hart & Moore, supra note 24, at 1120 ("[W]e identify a firm with the assets it possesses and take the position that ownership confers residual rights of control over the firm's assets . . . .").

[26] For these reasons, some scholars have suggested that shareholders in publicly-traded corporations should not be characterized as "owners." See, e.g., Stephen M. Bainbridge, Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship, 82 Cornell L. Rev. 856, 863 n.22 (1997) ("Because shareholders are simply one of the inputs bound together by the web of voluntary agreements, ownership should not be a particularly meaningful concept in nexus-of-contracts theory."); Margaret M. Blair, Corporate "Ownership": A Misleading Word Muddies the Corporate Governance Debate, Brookings Rev., Winter 1995, at 16.

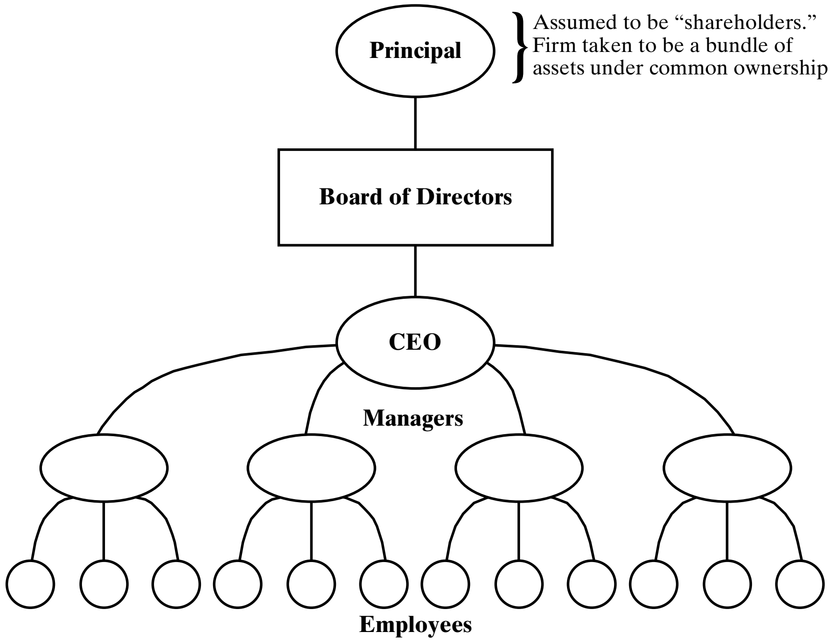

Figure 1.

In this view, there exists in every firm some principal who is the ultimate "owner" of the bundle of assets used by the firm in production. The owner is understood to delegate residual control rights to her agents (in the corporate context, the board of directors) who in turn are charged with managing the assets in the principal's interest, perhaps through several more layers of delegation. All the relationships of interest in the production process are vertical, however. Individuals at the upper levels of the hierarchy may delegate control over some assets to individuals below, but all ultimately work for (are "agents" of) the principal at the top. Thus the principal is understood to be the owner of the firm, as well as the residual claimant who receives all profits—that is, economic rents—left over after her contractual obligations to all the agents below her have been met.

In the rest of this Article, we refer to this conventional model of the firm as the "grand-design principal-agent model."[27] With one small modification—substituting a body of shareholders for a single owner at the top—this model has been the basis for most theoretical discussions about public corporations in recent years. And because the shareholder/owners at the top of the pyramid have been understood to be the residual claimants to all profits left over after all the corporations' contractual obligations have been met, the model has been used to argue that directors should run the firm for the sole purpose of maximizing the shareholders' interests.[28]

It should be noted that the grand-design principal-agent model incorporates a form of hierarchy. Economic theorists have only begun to study the many functions of hierarchy in detail, but much of what has been done generally supports the principal-agent interpretation of hierarchy's role. Thus hierarchy has been described as benefitting the principal at the top of the pyramid, for example by providing a mechanism by which information can be gathered by large numbers of people in the lower ranks of the hierarchy, aggregated and summarized and passed upward to those individuals at the higher levels who can best understand the big picture and make optimal decisions.[29] Similarly, in the corporate context,

[27] This rather awkward phrase combines several related ideas in the economic literature to describe what we believe to be the most common way that academics understand corporations. See Bengt R. Holmstrom & Jean Tirole, The Theory of the Firm, *in* 1 Handbook of Industrial Organization 61, 107 (Richard Schmalensee & Robert D. Willig eds., 1989) (noting that a common approach to modeling firms assumes "single comprehensive contracting" in which "owners impose a grand contract upon the entire hierarchy, preventing side . . . contracting between its members"); Jean-Jacques Laffont & Eric Maskin, The Theory of Incentives: An Overview, *in* Advances in Economic Theory (Werner Hildenbrand ed., 1982) (employing a grand contracting approach to modeling incentive systems within organizations that limit side-contracting and coalition formation); Jean Tirole, Hierarchies and Bureaucracies: On the Role of Collusion in Organizations, 2 J.L. Econ. & Org. 181, 181 (1986) ("[O]rganizations can be seen as networks of overlapping or nested principal/agent relationships.").

[28] See generally sources cited supra notes 1, 15 (discussing shareholder primacy).

[29] See Roy Radner, Hierarchy: The Economics of Managing, 30 J. Econ. Literature 1382, 1405 (1992) (reviewing economic literature on hierarchy as a system for gathering and processing information and noting that "[a] hierarchy . . . can be thought of as a cascade of principal-agent relationships, each supervisor acting as a principal in relation to his subordinates, and as an agent in relation to his own supervisor"); see also Kenneth J. Arrow, The Limits of Organization 53-59 (1974) (discussing organizations as processors of information).

shareholder delegation of decisionmaking authority to the board of directors has been defended as in the shareholders' best interests on the grounds that it allows for more efficient processing of information and decisionmaking.[30]

We agree that hierarchy in corporations can play an important role in gathering and processing information and in ensuring expert decisionmaking (although we believe that hierarchy can serve another critical function as well, which we discuss shortly). We are skeptical, however, about the emphasis in previous work on how hierarchy benefits the principal at the top of the hierarchical pyramid. We believe this emphasis misses the mark in describing what a public corporation is and why production is organized in corporations. The heart of the matter may lie in recognizing that some productive activities depend at least as much upon *horizontal* relationships as vertical ones. Put differently, some kinds of outcomes can only be achieved through joint effort—sometimes the joint effort of large numbers of people. If the activities and inputs of those participants are adequately coordinated, their collective output can be qualitatively different and vastly larger than the sum of what each individual could produce separately. Yet, transaction costs and other market imperfections often make it impossible to achieve the required coordination through impersonal individual exchanges in markets or even through a set of explicit contracts.[31]

Our break with previous work is to stress the importance of the coordination that happens not from the top down, but in the lateral interaction among team members. Hierarchical governance may still be needed in this context, but the role such governance serves is to mediate horizontal disputes among team members that may arise along the way. Thus when theorists simply substitute a body

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[30] See Gordon, supra note 8, at 353-57; see also Clark, supra note 8, at 781 (arguing that corporate law provides for directors to run the corporation instead of shareholders because "the basic rule of centralized management eliminates redundancy and waste in decisionmaking and facilitates the coordination of the multitude of activities that are carried out by a large, complex business").

[31] Thus Ronald Coase identified the coordination function as the key to distinguishing production within a firm from atomistic market exchanges. See Coase, supra note 19. Oliver Williamson's work on transaction cost economics similarly uses the coordination problem as the starting point for his analysis of hierarchies and markets as alternative coordination mechanisms. See Oliver E. Williamson, Markets and Hierarchies: Analysis and Antitrust Implications (1975).

of undifferentiated shareholders for the single owner at the top of the grand-design principal-agent model, they gloss over some of the most interesting and vexing problems of organizing team production. Closer analysis of corporate law reveals that it accomplishes something much richer and more interesting than merely chopping up the role of the principal at the top of the pyramid into smaller pieces.[32] In particular, the law of public corporations appears to actually *eliminate* the role of the principal, imposing in its place an internal governance structure—the mediating hierarchy—designed to respond to problems of horizontal coordination inherent in certain forms of team production.

B. Team Production Analysis of the Firm

1. Early Explorations of the Team Production Problem

One of the first serious attempts by economists to explore the problem of organizing joint production in teams can be found in a 1972 paper by Armen Alchian and Harold Demsetz.[33] In that paper, the authors 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."[34] Consider, for example, a group of expert researchers working on developing a new drug. Each makes a different contribution: identifying the active ingredient in some compound and the mechanism by which it affects human physiology; designing the production method; developing a purification process; testing for undesirable side effects. All expect to share in the benefits of what they hope will ultimately be a profitable enterprise. Yet because the outcome

[32] As Berle and Means pointed out more than six decades ago, doing this and selling the pieces to a large and diverse group of individuals alters beyond recognition the basic character of the shareholders' role in a fashion that invalidates the principal-agent relationship underlying the grand-design model. Berle & Means, supra note 11, at 3, 355 ("The property owner who invests in a modern corporation so far surrenders his wealth to those in control of the corporation that he has exchanged the position of independent owner for one in which he may become merely recipient of the wages of capital. . . . [Such owners] have surrendered the right that the corporation should be operated in their sole interest . . . .").

[33] Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 Am. Econ. Rev. 777 (1972).

[34] Id. at 779.

of their efforts—a successful product—is nonseparable, it may be impossible to determine who is "responsible" for what portion of the final output. Who is to say which team member's contribution was more valuable, when all were essential to the venture?

Team production of this sort poses a difficult problem when it comes to designing efficient incentives. If the team members agree in advance to allocate any profits according to some fixed sharing rule, obvious free-rider problems arise: Each team member will have an incentive to shirk, since he will get the same share of the total whether or not he works hard.[35] On the other hand, if the team members have no fixed sharing rule but simply agree to allocate rewards after the fact, when the time comes to divvy up the surplus all have incentives to indulge in wasteful rent-seeking, squandering time and effort haggling and trying to grab a larger share of the total output. The result in either case is suboptimal.

Alchian and Demsetz argued that hierarchies arise as a way to solve these problems. They proposed that in a hierarchical production system, one member of the team should be assigned the role of being a "monitor" who makes sure no one else shirks.[36] In order to motivate the monitor to do this well, the hierarchy should be arranged so that all the other team members become employees who are paid a fixed wage equal to their opportunity cost. In this way, the monitor receives all the residual returns or rents (all profits left over after the employees have received their fixed wages). Thus, the monitor has a strong incentive to police against shirking, while paying the other team members a fixed wage makes rent-seeking impossible.

In this early effort at thinking about team production, long-term relationships between employees and the monitor were deemed largely irrelevant.[37] This is true, however, only because of a peculiar feature of the Alchian and Demsetz model—it assumed that employees were undifferentiated inputs that were hired, or at least

[35] Total output might be smaller if one team member shirks, but if there are many team members, the shirking team member bears only a fraction of the cost in output lost due to his own shirking.

[36] See Alchian & Demsetz, supra note 33, at 781 ("One method of reducing shirking is for someone to specialize as a monitor to check the input performance of team members.").

[37] See id. at 777 ("[N]either the employer nor the employee is bound by any contractual obligations to continue their relationship.").

could be hired, in atomized markets. In other words, it viewed employees as interchangeable units that brought no special skills to—and, more importantly, made no special investment in—the team. Thus all could be paid a flat wage equal to their opportunity costs in a competitive market, with all the surplus from their joint efforts going to the monitor.[38]

The Alchian and Demsetz model, then, took a potentially rich story about economic gains from horizontal interaction among team members and, by reducing the team members to interchangeable parts that make no firm-specific investment, reformulated the team production problem as a vertical principal-agent problem. In doing so, their model provided a rationale for why one party to the team emerges as the "principal." But it also sidestepped some of the most interesting economic questions about teams, including: What are the sources of the economic surpluses in team produc-

[38] This stark, labor-as-commodity world implies that the source of the gains from joint production lies in the hands of the monitor/entrepreneur, perhaps because she controls a unique machine the workers utilize or knows best how to arrange the workers in relation to each other or in relation to the machines. Hence, where workers are undifferentiated inputs, it might seem perfectly natural to pay them only their marginal opportunity cost, while the entrepreneur who owns the capital equipment used by the firm receives all the surplus. See infra text accompanying notes 53-61 (discussing possibility that workers might also contribute unique inputs necessary to team production).

Alchian and Demsetz's underlying assumption that employees do not contribute unique inputs is reflected in their argument that it is inappropriate to think about the role of the monitor in "power" terms. See Alchian & Demsetz, supra note 33, at 777 ("[T]he firm . . . has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people. . . . Telling an employee to type this letter rather than to file that document is like my telling a grocer to sell me this brand of tuna rather than that brand of bread."). Property rights theorists more sensitive to the possibility that team production might require firm-specific inputs from more than one party have taken issue with this view. Thus Oliver Hart and John Moore have noted that if individual *A* needed to use unique assets controlled by *B* in order to be most productive, *B* can exercise considerable control over *A*. See Hart & Moore, supra note 24, at 1121 ("We suppose that the sole right possessed by the owner of an asset is his ability to exclude others from the use of that asset. . . . We shall see that control over a physical asset in this sense can lead indirectly to control over human assets."); see also Raghuram G. Rajan & Luigi Zingales, Power in the Theory of a Firm, 113 Q.J. Econ. 387 (1998) (identifying the regulation of access to resources as the mechanism by which participants in a joint production process acquire power over other participants who make specific investments).

tion, and how can they best be harnessed and directed? We shall return to reconsider this question.[39]

A 1982 paper by Bengt Holmstrom provided the next important contribution to the theory of controlling shirking in team production.[40] Alchian and Demsetz's approach assumed that their monitor could effectively detect and punish shirking among employees.[41] This assumption, however, ignores the key problem addressed by principal-agent theory—the difficulty of monitoring the agent. Holmstrom combined the agency cost problem with the free-rider problem in team production by asking: How can a monitor write an employment contract that provides appropriate incentives for each member of a team of hard-to-monitor employees not to shirk? In particular, Holmstrom examined whether it was possible to design a contract that prevented shirking and also satisfied a "budget constraint," meaning that all of the joint output from team production is allocated to members of the team.[42]

Holmstrom's conclusion—sometimes dubbed "Holmstrom's impossibility theorem"[43]—was that such a contract cannot be written.[44] Although Holmstrom's model is highly mathematical and abstract, the intuition is simple. If team members know with certainty in advance that they will receive some specified share—say 1/*n*—of the total surplus generated by the activity, regardless of the size of that surplus, it will always be optimal for them to shirk because they enjoy all the benefits of shirking but bear only 1/*n* of the cost. The only way to eliminate this disincentive is to make each team member bear the full cost of his own shirking. Unfortunately, since team members cannot be individually monitored, the only way to arrange this is to punish *all* the team's members (e.g., withhold payment from everyone) if there is evidence that any one of them

[39] Infra text accompanying notes 47-48.

[40] Bengt Holmstrom, Moral Hazard in Teams, 13 Bell J. Econ. 324 (1982).

[41] See Alchian & Demsetz, supra note 33, at 783 (noting that one of the "necessary conditions . . . for the emergence of the firm . . . [is that] [i]t is economical to estimate marginal productivity by observing or specifying input behavior").

[42] Holmstrom, supra note 40, at 325-28.

[43] See, e.g., Gary Miller, Tying the Owner's Hands: The Moral Hazard of Profit-Maximization, at 2 (July 21, 1996) (unpublished manuscript, on file with the Virginia Law Review Association). We thank Gary Miller for encouraging us to focus on the connection between our arguments and Holmstrom's theorem.

[44] See Holmstrom, supra note 40, at 327.

shirked. Such group incentives, however, break the budget constraint. If the team generates a surplus, but not enough to "prove" that no one shirked, where does the undistributed surplus go?

Holmstrom suggested that one answer might be to arrange for an outsider to absorb any surplus that is not distributed to the team members (or to eat occasional losses, depending on the terms of the contract), and hence "break the budget."[45] But because the outsider reaps a windfall if the team *fails* to meet its target, it is important that she not have any control rights she could use to influence the outcome of the team's efforts. Otherwise the "budget breaker" might, for example, bribe one team member to shirk a bit, in order to ensure that the team does not quite make its hurdle and the surplus all goes to the budget breaker.

Holmstrom accordingly argued that his model suggested a rationale for "separation of ownership and labor" in capitalist firms.[46] We think Holmstrom's theorem is quite important. We take issue, however, with an interpretation of his story that portrays shareholders in public corporations as outside "budget breakers" and executives and rank-and-file employees as team members. To the contrary, we argue that shareholders, executives, and employees are *all* team members, and that the budget breaker is *the corporation itself*—the fictional legal entity that, under the law, holds title to the firm's assets and serves as the repository for all its residual returns until they are paid out to shareholders or other stakeholders.

2. Reexamining the Team Production Problem: What are the Sources of Surplus?

To understand our argument, it is necessary to return to Coase and Oliver Williamson and to reexamine their reasons for stressing the hierarchical nature of firms. The essence of team production is that the whole can be made bigger than the sum of the parts. But how does that happen?

Both the grand-design principal-agent model examined earlier and the Alchian and Demsetz monitor-employee model focus on the gains to be had from vertical coordination between a principal/monitor and her agents/employees. We believe that such verti-

[45] Id. at 325.
[46] Id.

cal coordination can be an important source of gains, but we are inclined to believe that the *horizontal* interactions among team members are also quite important. With very few exceptions, however, economists who have modeled horizontal interactions among team members have focused on destructive pathologies in these interactions, such as collusive side agreements among team members seeking to cheat a principal. Thus horizontal interactions among team members generally have been viewed as things that need to be constrained (e.g., by the "grand design" contract) in order to keep the members of the organization focused on the principal's goals.[47]

Yet in many instances, it seems likely that horizontal interactions among team members may be the most important reason that teams are able to produce more than the sum of their individual inputs.[48] In these horizontal relationships, there is no clear "principal" and no clear "agent." Stout and Blair, for example, are jointly writing this Article. Neither of us is the "agent" to the other's "principal." Instead, we collaborate because we believe there are gains to both of us from collaboration, and we work out the details

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[47] See, e.g., Tirole, supra note 27, at 207 ("In our model, coalitions unambiguously decrease the efficiency of the vertical structure. Coalitions and their enforcement mechanism, side transfers, ought to be fought."); see also Bengt Holmstrom & Paul Milgrom, Regulating Trade Among Agents, 146 J. Institutional & Theological Econ. 85 (1990) (focusing on pathologies of side-contracting among agents). Interestingly, some notable Japanese scholars offer exceptions to the general rule that economists treat lateral interactions among team members as destructive (meaning, harmful to the principal) rather than as an important source of productive gains. See, e.g., Masahiko Aoki, The Contingent Governance of Teams: Analysis of Institutional Complementarity, 35 Int'l Econ. Rev. 657 (1994); Hideshi Itoh, Cooperation in Hierarchical Organizations: An Incentive Perspective, 8 J.L. Econ. & Org. 321 (1992).

[48] See generally David I. Levine, Reinventing the Workplace: How Business and Employees Can Both Win (1995) (surveying empirical evidence on use of employee involvement programs and their impact on corporate performance); Roger E. Alcaly, Reinventing the Corporation, N.Y. Rev. Books, Apr. 10, 1997, at 38 (discussing cultural changes resulting from collaborative work methods); Susan G. Cohen & Diane E. Bailey, What Makes Teams Work: Group Effectiveness Research From the Shop Floor to the Executive Suite (December 1996) (unpublished manuscript, on file with the Virginia Law Review Association) (noting increased use of teams in organizations, and reviewing recent research on teams and groups in organization settings). While economists have not paid much attention to the potential benefits of lateral interactions among team members, Jean Tirole notes that "it is widely recognized by sociologists that without the countless acts of cooperation that take place everyday between members, most organizations would break down." Tirole, supra note 27, at 208.

between us about who is responsible for what and who gets what out of the deal. We know vastly more about how to do what we are trying to do, and which of us is better situated to do which parts of the work, than any supervisor could know. We suspect that a great deal of economic production actually operates this way.

To observe that horizontal interactions in teams are probably an important source of economic gains is not to deny that there can also be destructive forms of horizontal interaction, especially wasteful rent-seeking behavior among the team members. To theorists who rely on a principal-agent model of the firm, however, the problems of collusion, side agreements, and rent-seeking are viewed primarily in terms of the harm they do to the *principal*. And they have been treated almost exclusively as problems to be solved by the principal through the clever design of incentives in a grand contract.[49]

There is another way to think about the problem, however. Because shirking and rent-seeking can erode or even destroy the gains that can be had from team production, it is also *in the collective interest of the team members* to minimize such behavior if the terms of the relationship among the team members call for them to share in any rents. How can the team members save themselves from their own opportunistic instincts? We believe that when the potential for shirking and rent-seeking is especially pronounced, team members as a group might prefer to relinquish control over both the team's assets and output to a third party—a "mediating hierarch"—whose primary function is to exercise that control in a fashion that maximizes the *joint welfare of the team as a whole*.

3. The Mediating Hierarchy as a Solution to Certain Team Production Problems

In making this argument, we rely heavily on insights developed in a recent paper by Raghuram Rajan and Luigi Zingales.[50] In that paper, the authors modeled the team production problem that confronts two people, *A* and *B,* who want to pursue a joint enterprise. In formulating the problem, however, Rajan and Zingales modified the team production analysis in a subtle but critical fashion. Spe-

[49] See generally Tirole, supra note 27; Holmstrom & Tirole, supra note 27.
[50] Rajan & Zingales, supra note 38.

cifically, they assumed that team production requires each member of the team to make an irrevocable commitment of resources to the joint enterprise. As an economist might put it, each must make a "firm-specific" investment.[51] Thus, for example, if *A* and *B* are researchers trying to develop a new pharmaceutical, each may have to invest time and skill that will be wasted if the venture fails.

When team production requires more than one party to make such a firm-specific investment, and when it is difficult to specify in advance the precise terms of each person's role in the enterprise, *A* and *B* face a dilemma. They must each make an irrevocable investment of resources if they want to maximize their potential for profit. Yet once they have done so, *A* and *B* will each find themselves at the other's mercy. Each party's specialized investment has little or no value outside the joint enterprise; neither can walk away from the venture and realize the value of the investment by selling it elsewhere. As a result, *A* and *B* have no choice but to deal with each other when deciding how to divide any profits they realize if the venture is successful. How can they make that joint decision?

If only one party is given control over the division of profits, the other will be reluctant to invest. Thus, for example, if *A* is given control over the joint enterprise and its assets, *A* can use that power to keep for herself all the rents over and above the minimum amount she must pay to keep *B* involved in the venture (generally, *B*'s opportunity cost in a competitive market). Thus *B* will have reason to fear that he will not enjoy any of the economic surpluses that flow from his firm-specific investment. As a result, the party without control rights will be discouraged from making necessary firm-specific investments.[52] If *A* and *B* agree to share decisionmaking authority, they run the risk that all their rents will be dissipated in ex post haggling. And if they agree in advance to a sharing rule, then they will both have incentives to shirk.

Scholars who adopt a property rights analysis have argued that, if both parties' investments are difficult to monitor and measure and to reduce to explicit contracts, the best solution is to allocate control rights over the joint venture ("ownership") to the party

[51] Id. at 392 ("The managers have to make an investment that is specific to the asset. This may consist of their specializing their human capital . . . .").

[52] Rajan and Zingales build on a model originally developed in Grossman & Hart, supra note 24 (formally modeling this problem).

whose specialized investment is most critical to the success of the enterprise.[53] (Indeed, it can be argued that exactly this solution is implicit in most closely held corporations, where share ownership and managerial control both tend to be concentrated in the hands of a small group of individuals whose contributions are critical to the venture's success.)[54] Thus, if *A*'s contribution to the research effort is more vital than *B*'s, the best we can do is to protect and encourage *A*'s investment by making *A* the "owner" of the enterprise. *B* will then be left to negotiate the best contract he can, but since his contribution, too, is complex and difficult to reduce to contract, *B* will probably invest suboptimally since he cannot get full contractual protection for his firm-specific investments.

Rajan and Zingales note, however, that assigning ownership to *A* not only does not ensure optimal investment by *B*—it also may not ensure optimal investment by *A*. In particular, even if *A* has control rights, *A* might not have sufficient incentive to make the specialized investment if, instead, she can capture a significant share of the rents from the enterprise simply by selling her stake to someone else who might want to run the firm. Thus, if *A* is given ownership of the pharmaceutical research venture, she might decide to profit from *B*'s irrevocable investment not by adding her own efforts, but by threatening to sell the entire venture to *C*.[55]

This analysis suggests that a property rights solution to certain team production problems suffers from a serious shortcoming. Although property rights can protect at least one team member's specialized investment, they can also empower that "owner" to capture rents by exploiting the other member's specialized invest-

[53] See, e.g, id. at 708; Hart & Moore, supra note 24, at 1149 ("[A]n agent is more likely to own an asset if his action is sensitive to whether he has access to the asset and is important in the generation of surplus . . . ."). Jonathan Macey has made a related argument by suggesting that corporate law should adhere to the shareholder primacy norm because, although other groups also make firm-specific investments in corporations, nonshareholders can protect themselves adequately through contracts. See Macey, supra note 5, at 174-78.

[54] See infra text accompanying notes 72-75 (discussing distinction between private and public corporations).

[55] Rajan and Zingales set up an analytical model and solve for the conditions in which owner *A* maximizes her private returns by threatening to sell out rather than undertaking the enterprise (because undertaking the enterprise means making a specialized investment and sharing the rents with *B*), while social returns are reduced. See Rajan & Zingales, supra note 38, at 408.

ments without bothering to make such investments herself. As an alternative solution, Rajan and Zingales suggest that both team members might improve their welfare by agreeing *to give up control rights to a third party*, an "outsider" to the actual productive activity.[56] This outsider makes no firm-specific investment herself. She is, however, given control over the team's assets, as well as the right to allocate output among team members and to fire individual team members or even break up the team. In return, the outsider is rewarded with a nominal share of the team's output.[57] As a result, the outsider has an incentive to choose an efficient and productive team (that is, the team whose members all make the necessary firm-specific investments). Meanwhile, team members also feel they can now safely invest.

This idea is intriguing for several reasons. First, unlike Alchian and Demsetz's theory, it emphasizes that individuals will only want to be part of a team if by doing so they can share in the economic surplus generated by team production. Second, it recognizes that team members intuitively understand that it will be difficult to convince others to invest firm-specific resources in team production if shirking and rent-seeking go uncontrolled. Thus, they realize that it is in their own self-interest to create a higher authority—a hierarch—that can limit shirking and deter rent-seeking behavior among team members. *In other words, team members submit to hierarchy not for the hierarch's benefit, but for their own.*[58]

[56] See id. at 422 ("[I]f all the parties involved in production (i.e., including the entrepreneur) have to make substantial specific investments over time, it may be optimal for a completely unrelated third party to own the assets. . . . [T]he third party holds power so that the agents critical to production do not use the power of ownership against each other.").

[57] Rajan and Zingales interpret their story as providing a rationale for the separation of share ownership in a corporation from labor inputs. See id. at 422-24. This seems like an odd interpretation, however, because the third party "owner" in the Rajan and Zingales model is not a residual claimant. We reinterpret their third party "owner" as the corporation itself, the separate legal entity in which ownership rights over assets used in production are vested, and which is in turn run by an independent board of directors whose members usually receive a fixed fee or perhaps some equity shares for their services.

[58] This basic idea is central to much modern political theory, and can be traced back at least to Thomas Hobbes. See Thomas Hobbes, Leviathan (C.B. MacPherson ed., Penguin Books 1968) (1651). Hobbes's notion that people might submit themselves to a coercive monarch in order to avoid the "warre of every one against every one,"

Let us explore how this idea might apply to corporations. The Alchian and Demsetz explanation for the emergence of hierarchy assumed away any productive advantages from horizontal interactions among specialized team members. Thus their solution gave all the rents to the monitor, leaving employees with no stake in the enterprise and no firm-specific investment. Similarly, the grand-design principal-agent model assumes that a firm is formed when a single entrepreneur willing to make a specialized investment (perhaps by contributing a unique idea or machine) wants to expand production beyond what she can produce by herself. The entrepreneur hires others to carry out her orders, but remains in control of the firm-specific investment that is the source of the surplus in the planned production.[59]

Yet if all the potential value of an enterprise truly emanated from the firm-specific investment of a single individual, why would that individual need to form a public corporation to hire workers and expand production? Presumably, she could use simple employment contracts or adopt an alternative business form such as a limited partnership or closely held company. This fact suggests that the typical public corporation may reflect a quite different—and we believe quite common—scenario. In reality, the public corporation is not so much a "nexus of contracts" (explicit or implicit) as a "nexus of firm-specific investments," in which several different groups contribute unique and essential resources to the corporate enterprise, and who each find it difficult to protect their contribution through explicit contracts.[60]

In this scenario, a number of individuals come together to undertake a team production project that requires all to make some form of enterprise-specific investment. Perhaps one individual brings critical technical skills to the table, while another has a talent for management, and a third provides marketing insights. They may lack financial capital, however, so they seek out wealthy friends or

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id. at 189, focuses on horizontal relationships that are perhaps better described as "team destruction" rather than "team production." His proposed solution parallels our own, however.

[59] See Raghuram G. Rajan & Luigi Zingales, The Firm as a Dedicated Hierarchy (Jan. 9, 1998) (unpublished manuscript, on file with the Virginia Law Review Association) (modeling a firm that explicitly assumes this structure).

[60] Id. at 3 ("What is critical to the firm, in our view, is the core, which is largely a *web or nexus of specific investments* (and any property rights to crucial assets).").

family members to put up initial funding. Thus, a team is born. Undertaking team production, however, requires each of the members to make irrevocable investments that leave them vulnerable to opportunistic exploitation by other team members. The marketing specialist, for example, must develop specialized knowledge and personal contacts (firm-specific human capital) whose value is vulnerable to actions and decisions of the team as a whole-likewise for the technical specialist. And while the cash contributions of financial investors may initially be generic and fungible, once those funds have been used to purchase specialized assets or to pay wages, they effectively become sunk in the firm.[61]

Despite their mutual vulnerabilities, the team members expect for the most part to be able to get along with each other and figure out how to allocate tasks and divide up rewards as they go. When disputes arise, however, they want a decisionmaking procedure in place that all believe will be fair. The solution? They form a public corporation.

C. The Public Corporation as a Mediating Hierarchy

Let us see how forming a public corporation can be understood as creating a mediating hierarchy. When a productive team incorporates, one of the first tasks the law demands of the team is to select a board of directors to be given authority to make decisions for the corporation.[62] This board may include several team members or their representatives, but it may also include (and in public corporations almost invariably does) several outsiders. The board enjoys ultimate decisionmaking authority to select future corporate officers and directors, to determine the use of corporate assets, and to serve as an internal "court of appeals" to resolve disputes that

[61] While one shareholder might be able to sell her shares at a reasonable price, if all try to sell their stock at the same time, they will lose a significant portion of their investment. Similarly, creditors place their capital at risk and make additional firm-specific investments when they spend resources researching a particular company. Rank-and-file employees make firm-specific investments when they acquire company-specific skills (including familiarity with the firm's business culture), and even the local community may make firm-specific investments if, for example, it builds roads, schools, or other infrastructure to meet the needs of the firm or its employees.

[62] See, e.g., Del. Code Ann. tit. 8, § 108 (1974 & Supp. 1996).

may arise among the team members.[63] The net result is that, by forming a corporation, the original team members *all agree to give up control rights over the output from the enterprise and over their firm-specific inputs*. Providers of financial capital—shareholders and even, potentially, some creditors—are, by this agreement, just as "stuck" in the firm as are providers of specialized human capital.

The act of forming a corporation thus means that *no one team member is a "principal"* who enjoys a right of control over the team.[64] To the contrary, once they have formed a corporation and selected a board, the team members have created a new and separate entity that takes on a life of its own and could, potentially, act against their interests, leading them to lose what they have invested in the enterprise. Knowing that incorporating means losing influence over the corporation's future and over the division of the rents the corporation generates,[65] why would any of the team members do this?

The answer is that team members understand they would be far less likely to elicit the full cooperation and firm-specific investment of other members if they did not give up control rights. Thus, ex

[63] As we discuss later at greater length, corporate law generally grants shareholders a right to elect directors at least annually. Although this right is often interpreted to mean that shareholders have ultimate control over the board, in practice the existing board usually controls the nominating process. Moreover, the views of top management have considerable influence in that process, suggesting that the actual degree of control conveyed by shareholder voting rights is quite limited. We argue later that shareholder voting rights may amount to little more than a "thumb on the scale" in their favor to offset the considerable control and influence exercised by management. See infra Section II.D.

[64] Team members who are actively involved in the business as employees or directors, however, may themselves be "agents" for the corporation as a whole, with all the fiduciary obligations to the corporation that status implies. See generally Scott E. Masten, A Legal Basis for the Firm, *in* The Nature of the Firm: Origins, Evolution, and Development, supra note 19, at 196 (discussing legal responsibilities of employees as "agents" of the corporation).

[65] An example can be found in the case of Apple Computer, Inc., originally founded by Steven Jobs and Steven Wozniak in Jobs's garage in 1976. Apple grew to become a one billion dollar company during its first eight years. But by 1985, Wozniak had resigned, and Jobs had been stripped of his day-to-day management responsibilities by the board, which hired John Sculley to run the company. Jobs then resigned as chairman of Apple's board. See Christine Winter, Founder Jobs' Future Role Remains Major Mystery at Apple, Chi. Trib., June 10, 1985, § 4, at 4. Although Apple's board convinced Jobs to come back as chairman in late 1996, during the interim 11 years Jobs had clearly lost control and influence at Apple. See John Markoff, Steven Jobs Making Move Back to Apple, N.Y. Times, Dec. 21, 1996, at 37.

ante, they judge their chances of capturing some of the significant rents that can flow from team production to be greater if they give up control to a decisionmaking hierarchy, than if they attempted to write detailed contracts with the other participants. This analysis suggests that hierarchy can perform a third function in addition to the two economists have identified (streamlining information-gathering and decisionmaking, and controlling shirking through the cascade of sequential principal-agent contracts). This third function is *encouraging firm-specific investment in team production by mediating disputes among team members about the allocation of duties and rewards*.

Our argument suggests that it is misleading to view a public corporation as merely a bundle of assets under common ownership. Rather, a public corporation is a team of people who enter into a complex agreement to work together for their mutual gain. Participants—including shareholders, employees, and perhaps other stakeholders such as creditors or the local community—enter into a "*pactum subjectionis*"[66] under which they yield control over outputs and key inputs (time, intellectual skills, or financial capital) to the hierarchy. They enter into this mutual agreement in an effort to reduce wasteful shirking and rent-seeking by relegating to the internal hierarchy the right to determine the division of duties and resources in the joint enterprise. They thus agree not to specific terms or outcomes (as in a traditional "contract"), but to participation in a process of internal goal setting and dispute resolution.[67] Hence the mediating hierarchy of a corporation can be viewed as a substitute for explicit contracting that is especially useful in situations where team production requires several different team members to make various kinds of enterprise-specific investments in projects that are complex, ongoing, and unpredictable.[68]

[66] This phrase refers to the supposed pact that existed between the king and his subjects in medieval Europe. United States v. Standard Oil Co., 60 F. Supp. 807, 811 (S.D. Cal. 1945), rev'd, 153 F.2d 958 (9th Cir. 1946), aff'd, 332 U.S. 301 (1947).

[67] Although property rights over the alienable assets and the output of the firm are important in this model, they are not the defining feature of "the firm." Rather, property rights are merely instrumental to team production, providing the basis for the hierarch's power to deter shirking and rent-seeking by the individuals below them in the hierarchy.

[68] Although some contractarian legal scholars may find this view of the role of managers and directors controversial, it is important to note that contract theory itself as-

The net result is a corporation whose structure looks much more like Figure 2, than the grand-design principal-agent structure illustrated in Figure 1.[69] Within the firm, there are several layers of hierarchy, and in each layer the relevant hierarch (the "boss") has authority to resolve disputes among members at lower levels. The peak of the pyramid is occupied not by some owner/principal, but by a board of directors whose job includes serving as the final arbiter in disputes that cannot be resolved at lower levels. At any point in time, members at lower levels who are unhappy about a boss's decision—whether the board's or some lower manager's—can choose to leave the firm. If they leave, however, they lose the value of their firm-specific investments and can no longer share in the residual rents generated by the enterprise. Similarly, if the hierarchy so decides, dissenting team members can be forced out of the coalition and cut off from sharing in future rents. Thus if they choose to stay, team members must abide by the decisions of the hierarchy about the division of duties and rewards.[70]

sumes the existence of independent hierarchs—that is, third party enforcers such as police and courts—to enforce contractual terms. See infra text accompanying note 79 (discussing other institutions that use hierarchs).

[69] See supra Section I.A.3.

[70] Of course, external law and explicit contracts may also impose limits on how duties and rents can be divided up. For example, union contracts may specify limits on work assignments, or seniority rules for layoffs, and laws against discrimination and sexual harassment attempt to set boundaries on what managers can order employees to do or for what reasons employees can be fired. But within those broad boundaries, employees give their managers wide discretion. See Oliver E. Williamson, The Economic Institutions of Capitalism 249 (1985) (referring to the area within those broad boundaries as the "zone of acceptance").

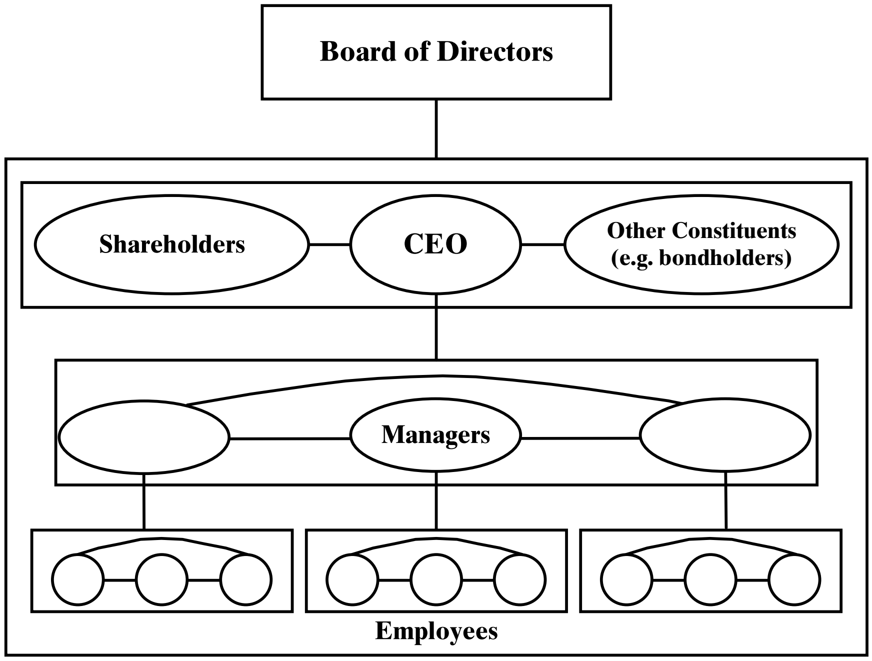

Figure 2.

When the mediating function is added to the story of what hierarchy accomplishes, it is no longer obvious that employees should be viewed as agents of the hierarchs to whom they report, as the grand-design principal-agent model suggests. Instead, it can be argued that *hierarchs work for team members (including employees)* who "hire" them to control shirking and rent-seeking among team members.[71] This is true at each level in the organization, from first level managers up to the board. Thus, the primary job of the board of directors of a public corporation is not to act as agents who ruthlessly pursue shareholders' interests at the expense of employees, creditors, or other team members. Rather, the directors are trus-

[71] This view of things calls to mind an arresting example offered by Steven Cheung. According to Cheung, it was common in China before the rise of communism for laborers to hire themselves out as teams to pull boats upriver. More significantly, the laborers would also agree among themselves to hire a third party to whip any member of the team who seemed to be flagging. Steven N.S. Cheung, The Contractual Nature of the Firm, 26 J.L. & Econ. 1, 8 (1983).

tees *for the corporation itself*—mediating hierarchs whose job is to balance team members' competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together.

Before we explore the implications of this view for corporate law further, it is important to note that the mediating hierarchy model is subject to several important caveats. First, the model applies primarily to public—not private—corporations. As we demonstrate in Part II, directors of public corporations with widely dispersed share ownership are remarkably free from the direct control of any of the groups that make up the corporate "team," including shareholders, executives, and employees.[72] Although directors have incentives to accommodate the interests of all these groups, they are under the command of none. In contrast, in a closely held firm, stock ownership is usually concentrated in the hands of a small number of investors who not only select and exercise tight control over the board, but also are themselves involved in managing the firm as officers and directors.[73] Thus the typical private corporation adheres more closely to the grand-design principal-agent model of the firm than to the mediating hierarchy model.[74] This in turn suggests that the choice to "go public" may be driven in part by team production considerations. For example, when a single individual or small group of individuals conceives, creates, operates, and contributes much of the initial capital necessary to start a business, they will likely prefer to keep their firm closely held. In time, however, the individual or group may seek a relationship with another group willing to invest substantial firm-specific resources (say, outside investors to contribute equity capital, or outside professional managers to take on the burdens of day-to-day administration of the firm). At this point, the original entrepreneurs may conclude that it is in their best interest to opt into the mediating hierarchy model by going public. In other words, rational entrepreneurs prefer doing business as a private firm when team production

[72] See infra Part II.

[73] See generally Clark, supra note 8, at 772-84 (describing private corporations).

[74] In this context, the phrase "private corporation" refers not only to businesses that meet the sometimes-narrow statutory definition of a private firm, see, e.g., Del. Code. Ann. tit. 8, § 342 (1974) (defining close corporation), but also to companies that are nominally held by the public but effectively controlled by a single shareholder or group of shareholders.

inefficiencies are less of a problem, either because one individual's or group's firm-specific investment is more critical to the enterprise's success than any other's, or because there are relatively few obstacles to explicit contracting over the division of any surplus.[75]

Second, it is important to recognize that, by suggesting that directors serve at the top of the pyramid of authority that comprises the public corporation, the mediating hierarchy model does not imply that directors actually manage the corporation on a day-to-day basis. To the contrary, we expect that most corporate decisions are made collegially among team members at lower levels. Indeed, the existence of a mediating hierarchy may heighten incentives for team members to work out conflicts among themselves because the alternative is kicking the problem upstairs to a disinterested—but potentially erratic or ill-informed—hierarch. Thus an independent board of directors may be able to encourage shareholders, executives, and employees to invest in corporate production not because these team members expect the board to determine which group gets what portion of the resulting economic surplus, but because the possibility that the board *could* make that allocation discourages the more egregious forms of shirking and rent-seeking among team members. Only rarely is it necessary for directors to fire an executive officer for paying herself an immense salary while corporate profits are declining. In most cases such blatant opportunism will be discouraged by the executive's knowledge that the board *could* fire her.

Third, the mediating hierarchy model does not imply that all the individuals and groups that make firm-specific investment in a public corporation will receive equal, or fair, shares of the surplus generated from team production. It is important that each team member whose firm-specific investment is essential to the corporate enterprise receive at least *some* portion of the economic surplus; otherwise, any member excluded from the surplus could do just as well by exiting the coalition and investing his resources elsewhere. However, so long as each member of the coalition receives even a modest premium over his opportunity cost, he has incentive to remain in the team. Thus—and especially when the rewards from team pro-

[75] See supra text accompanying notes 53-61 (discussing single owner solution to team production).

duction are very large—there can be significant disparities in the share each team member receives without threatening the team's existence. These disparities, moreover, may be driven more by political power than by economic factors.[76]

Fourth, by suggesting that corporate directors serve as disinterested trustees charged with protecting the interests of all the members of the corporate coalition, the mediating hierarchy model does not require directors to be unselfish altruists. Directors are compensated, often quite handsomely, for their services to the coalition. This gives them an incentive to try to maintain their positions by satisfying the minimum demands of all of the important corporate constituencies, lest some critical constituents withdraw and the coalition fall apart. (After all, if the team falls apart, the directors lose their jobs.)[77] Although this is not a tight constraint, it discourages extreme abuses, and later we discuss in greater detail other influences that may also help to keep directors faithful.[78]

More importantly, discouraging extreme abuses may be enough. In arguing that a mediating hierarchy can be an efficient response to problems of contracting over team production, we do not intend to suggest that it is a perfect solution. Most obviously, placing ultimate control of a business enterprise in the hands of a board of directors whose members have little or no direct stake in the firm exacerbates principal-agent problems. Nevertheless, team members who adopt a mediating hierarchy may in some cases gain more from constraining shirking and rent-seeking than they lose to agency costs. For example, suppose a lazy or careless board of directors wastes fifty percent or more of the economic rents that flow from team production. Team members might still regard themselves as better off in a public corporation managed by a board of directors than they would be under an alternative system (such as a closely held firm controlled by one of the team members) if the alternative so discouraged firm-specific investment by other team

[76] See infra text accompanying notes 195-204 (discussing how political and economic factors determine how large a portion of the surplus each team member receives).

[77] Even if the team stays together, reputational considerations may encourage directors to channel their energies into keeping all the important members reasonably happy, in order to get invitations to join still more boards.

[78] See infra text accompanying notes 118-20 (discussing legal rules prohibiting directors from using their positions for personal benefit) and 152-60 (discussing role of social norms and expectations about fiduciaries).

members that virtually all of the benefits of joint production were lost. In other words, if the likely economic losses to a productive team from unconstrained shirking and rent-seeking are great enough to outweigh the likely economic losses from turning over decisionmaking power to a less-than-perfectly-faithful hierarch, mediating hierarchy becomes an efficient second-best solution to problems of team production.

This sort of second-best solution, moreover, is surprisingly common. Corporate boards of directors are only one of many institutions in our society that rely upon some form of disinterested hierarch to resolve disputes between parties for whom resolution through explicit contracting is too costly. Other examples include the referee in a football game; the trustee who administers a trust for multiple, competing beneficiaries; and the judge who renders a decision in litigation between parties. This observation raises a final question about applying the mediating hierarchy model to public corporations—namely, why should we put the board of directors (instead of, say, a judge) at the top of the hierarchical corporate pyramid?

The mediating hierarchy model of the public corporation necessarily implies that authority for making some allocative decisions—those that take place "within" the firm—ultimately rests with the board of directors, whose decisions cannot be overturned by appealing to some outside authority, like a court. This claim should not be read too broadly. When members of the hierarchy behave in ways that threaten the hierarchy itself (as when corporate directors violate their duty of loyalty to the firm through self-dealing), courts will intervene.[79] Similarly, courts generally enforce explicit contracts among team members allocating rights and duties (such as contracts with creditors or employees) and external laws that set minimum terms or ground rules for transactions within firms (such as minimum wage laws). Courts will not normally intervene, however, to settle an internal dispute over transfer prices between two units or subsidiaries of the same corporation, or between two individuals in a firm over work assignments, promotions, or division of

[79] See infra text accompanying notes 118-49 (discussing judicial enforcement of directors' fiduciary duties).

a bonus pool.[80] As Williamson has put it, "[t]he implicit contract law of internal organization is that of forbearance."[81]

This forbearance reflects the fact that in many situations where team members find explicit contracting too costly, there are a variety of reasons to prefer mediation that stops at the level of the board. Internal mediation has great advantages over courts and other external dispute resolution mechanisms, particularly in situations that involve repeated interactions among the contending parties and between the contending parties and the mediator. For example, internal decisions are made by people who know more about the special circumstances of any dispute, and who generally have a stake in seeing that the resolution truly settles the dispute and reduces the tensions created by the dispute. Internal decisionmaking processes and decisions can be less formal, more flexible, and better able to deal with subtleties. Whereas court decisions tend to be zero-sum, internal decisionmakers can use tradeoffs that avoid or side-step zero-sum games ("I can't give you the raise this month, but I'll go ahead and give you the larger office now, and in the next fiscal year, I can probably give you the raise."). Or they can pressure team members to work it out among themselves, under the threat that either or both could be "fired" (or reassigned or otherwise punished) if they fail to work it out.

The mediating hierarchy model consequently suggests that the public corporation can be viewed most usefully not as a nexus of implicit and explicit contracts, but as a nexus of firm-specific investments made by many and varied individuals who give up control over those resources to a *decisionmaking process* in hopes of sharing in the benefits that can flow from team production. We realize that this approach may seem odd—even counterintuitive—to corporate

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[80] See Oliver E. Williamson, Comparative Economic Organization: The Analysis of Discrete Structural Alternatives, 36 Admin. Sci. Q. 269, 274 (1991) (noting that "courts routinely grant standing to firms [suing other firms] should there be disputes over prices, the damages to be ascribed to delays, failures of quality, and the like, [but] . . . refuse to hear disputes between one internal division and another over identical technical issues").

[81] Id. George Baker, Robert Gibbons, and Kevin J. Murphy similarly distinguish a relationship between a buyer of services and an employee within a firm, from a relationship between a buyer of services and an independent contractor, by whether "disputes have standing in court." George Baker et al., Implicit Contracts and the Theory of the Firm 14 (Apr. 17, 1997) (unpublished manuscript, on file with the Virginia Law Review Association).

theorists accustomed to thinking of corporations in terms of a grand-design principal-agent model where shareholders are the principals and directors are their agents. Nevertheless, our claim that directors should be viewed as disinterested trustees charged with faithfully representing the interests not just of shareholders, but of all team members, is consistent with the way that many directors have historically described their own roles.[82] Our claim also resonates with the views of legal scholars who argue that directors *should* view their jobs in these terms.[83] Most importantly, our

[82] For example, in 1946 Frank Abrams, then chairman of Standard Oil Company of New Jersey, described the goal of the modern corporation as maintaining "'an equitable and working balance among the claims of the various directly interested groups—stockholders, employees, customers, and the public at large.'" Eugene V. Rostow, To Whom and for What Ends Is Corporate Management Responsible?, *in* The Corporation in Modern Society 46, 60 (Edward S. Mason ed., 1959). Similarly, in 1971, the American Can Company stated in its annual report that "'[i]n our changing social contract . . . management must satisfy the legitimate needs of all three participating partners—our customers, our owners and our employees'" Robert J. Samuelson, I Love Coke's Report, Wash. Post, Apr. 16, 1997, at A17. In 1978, the directors of Control Data gave formal recognition to a similar view in its proxy statement to shareholders by urging them to amend the company's articles of incorporation to require the board to consider the effects of any takeover proposal on the company's employees and other stakeholders, noting that "'[t]he Board is mindful and supportive . . . of the growing concept that corporations have a social responsibility to a wide variety of societal segments which have a stake in the continued health of a given corporation.'" Margaret M. Blair, Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century 212 n.19 (1995) (quoting Control Data Corp., Proxy Statement, May 3, 1978, at 4). The culture of the boardroom seems to have changed in recent years so that directors are more reluctant to make such statements. See infra text accompanying notes 181-88, 207-208 (discussing change in culture).

Prominent Japanese scholars also have long viewed the corporation in terms of its role in balancing competing interests. See, e.g., Masahiko Aoki, The Co-operative Game Theory of the Firm (1984) (exploring a model of the firm that assumes that managers and directors act as mediators between providers of finance capital and providers of labor, and that rents are allocated between these two constituencies by management according to the relative power of each group). Some management theorists have also described managers' and directors' role this way. See e.g., Murray L. Weidenbaum, Updating the Corporate Board, *in* Business and Society: Dimensions of Conflict and Cooperation 310, 317 (S. Prakash Sethi & Cecilia M. Falbe eds., 1987) ("Much of the modern management literature refers to the need for top management to balance the desires of employees, customers, suppliers, public-interest groups, and shareholders.").

[83] See supra note 16 (reviewing the progressive school of corporate scholarship). Our argument departs from those of the progressives because the latter commonly argue that corporate directors do not take sufficient account of nonshareholders' interests and that changes in the law are required to make this happen. See, e.g., O'Connor,

model of corporations is consistent with the law itself. Thus we argue in the rest of this Article that public corporation law can be best explained in terms of the mediating hierarchy model.

II. A Team Production Analysis of the Law of Corporations

During the past two decades, corporate scholarship has been dominated by a "contractarian" or "law and economics" approach that generally adopts some version of the grand-design principal-agent model of the firm and, as a consequence, also takes as given that corporations should be governed according to the norm of shareholder primacy.[84] Thus, most contemporary corporate scholars tend to assume that directors' proper role is to maximize the economic interests of the corporation's shareholders.[85] Recent years, however, have seen the rise of a second, opposing camp of theorists known as "communitarians" or "progressives." These scholars object to shareholder primacy on normative grounds, and argue that directors ought to be required to run corporations with due regard for the interests of other potential stakeholders such as employees, creditors, customers, suppliers, or the local community.[86]

Despite their many differences and disagreements, both the law and economics scholars and their progressive opponents share a common assumption: that, as a descriptive matter, American corporate law follows the shareholder primacy model.[87] In other words, both camps believe that directors are controlled by, and owe extracontractual legal duties only to, shareholders. Two important features of U.S. corporate law appear to support this assumption.

supra note 16 (arguing that directors should operate as "neutral referees" and proposing legal requirement that employees be represented in the boardroom).

[84] See sources cited supra notes 1, 15.

[85] Id.

[86] See sources cited supra note 16.

[87] See Michael P. Dooley, Fundamentals of Corporation Law 97 (1995) ("[I]t is generally agreed that management's principal fiduciary duty is to maximize the return to the common shareholders."); David Millon, Communitarians, Contractarians, and the Crisis in Corporate Law, 50 Wash. & Lee L. Rev. 1373, 1374 (1993) ("[S]hareholder primacy has served as corporate law's governing norm for much of this century."); Smith, supra note 15, at 280 ("The assumption that the shareholder primacy norm is a major factor in the ordinary business decisions of boards of directors of modern, publicly-traded corporations is pervasive in modern corporate law scholarship.").

The first is the "derivative suit," a legal procedure that allows shareholders in some circumstances to file suit on behalf of the corporate entity against directors accused of breaching their duties to the firm. Because such substitute standing is usually granted only to shareholders, the derivative suit can be viewed as evidence that directors owe fiduciary duties to shareholders but not to other stakeholders, such as creditors and employees.[88] The second feature of U.S. corporate law that seems to argue for shareholder primacy is shareholder voting rights. Unlike other stakeholders, shareholders are nominally entitled to elect (and, under some circumstances, to remove) corporate directors, and to vote on "fundamental" corporate changes.[89] These voting rights appear to give shareholders a unique measure of control over how the firm is run.

Because only shareholders normally enjoy voting rights and derivative standing, it seems natural to infer that corporate law intends directors to be subject only to shareholders' control and to serve only shareholders' interests. We argue below, however, that a more careful inspection of American corporate doctrine reveals compelling reasons to question this description of the relationship. Corporate law does not treat directors as shareholders' agents but as something quite different: independent hierarchs who are charged not with serving shareholders' interests alone, but with serving the interests of the legal entity known as the "corporation." The interests of the corporation, in turn, can be understood as a joint welfare function of *all* the individuals who make firm-specific investments and agree to participate in the extracontractual, internal mediation process within the firm. For most public corporations, these are primarily executives, rank-and-file employees, and equity investors, but in particular cases the corporate team may also include other stakeholders such as creditors, or even the local community if the firm has strong geographic ties.

We explore this interpretation of "the corporate interest" below and conclude that it offers a more accurate picture of American statutory and case law than does the shareholder primacy assumption. In particular, we argue that public corporation law encourages

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[88] See infra Section II.B (describing derivative suits).

[89] See infra Section II.D (describing shareholders' voting rights and practical obstacles to their effective exercise).

directors to serve the joint interests of *all* stakeholders who comprise the corporate "team" by generally insulating them from the demands of *any* single stakeholder group, including the shareholders. While in certain limited circumstances shareholders enjoy special rights not granted to other stakeholders, these rights are merely instrumental. Shareholders enjoy special legal rights not because they have some unique claim on directors, but because they often are in the best position to represent the interests of the coalition that comprises the firm. Thus, when directors breach their fiduciary duties and seek to profit personally at the firm's expense, shareholders sometimes can take legal action on the firm's behalf. As a general rule, however, the benefits of such derivative actions inure not just to shareholders, but to *all* stakeholders. Similarly, shareholders' limited voting rights may operate to benefit other stakeholders in the firm.

We conclude that—unlike the grand-design principal-agent model, which seems at odds with much of American corporate law—the mediating hierarchy approach provides a solid theoretical foundation for the basic structure of public corporation law. This conclusion, moreover, contains both positive and normative components. From a positivist perspective, the way corporate law actually works in practice is consistent with the notion that directors are independent hierarchs whose fiduciary obligations run to the corporate entity itself and only instrumentally to any of its participants. From a normative basis, a team production analysis suggests that this is how the law *ought* to work. By preserving directors' independence and imposing on them fiduciary obligations that run to the firm as a whole and not to any particular team member, corporate law reinforces and supports an essential economic role played by hierarchy in general, and by corporate boards of directors in particular.[90]

[90] In describing what corporation law does and does not permit, we recognize that many of the legal rules to which we refer are default rules that apply only in the absence of a countervailing provision in a corporation's charter or bylaws. Corporations in theory could adopt structures that depart from these rules. Many of the rules we discuss, however, are substantive requirements to which all public corporations must adhere. See, e.g., Del. Code Ann. tit. 8, § 203 (1974 & Supp. 1996) (allowing charter provisions that insulate directors from personal liability for breach of the duty of care but not breach of the duty of loyalty). Moreover, when the transaction costs associated with adopting a particular charter or bylaw provision are high, default rules tend to operate as substantive rules. Finally, a recent study has found that when

A. Directors' Legal Role: Trustees More than Agents

In exploring the relative advantages of the mediating hierarchy model of the public corporation, we begin by examining one of the greatest weaknesses of the prevailing grand-design principal-agent approach: its assumption that directors are agents of the firm's shareholders. The notion that directors are shareholders' agents has exerted enormous influence in the theoretical literature.[91] Nevertheless, as Dean Robert Clark has pointed out, from a legal perspective it is a highly misleading description of the relationship between directors, shareholders, and the firm.[92] Clark summarizes the law on the question as follows:

> (1) corporate officers like the president and treasurer are agents of the corporation itself; (2) the board of directors is the ultimate decision-making body of the corporation (and in a sense is the group most appropriately identified with "the corporation"); (3) directors are not agents of the corporation but are sui generis; (4) neither officers nor directors are agents of the stockholders; but (5) both officers and directors are "fiduciaries" with respect to the corporation and its stockholders.[93]

As this description reveals, corporate directors are not agents in a legal sense. The rules of agency provide that an agent owes her principal a "duty of obedience"—in other words, the principal enjoys control over, and has the power to direct the actions of, the agent.[94] Corporate directors depart radically from this model. As the ultimate decisionmaking body within the firm, they are not subject to direct control or supervision by *anyone*, including the firm's shareholders. Moreover, this fundamental principle of directorial discretion cannot be explained away as a legal response to the

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corporations "going public" do take the trouble to adopt charter provisions that alter directors' legal rights and responsibilities, these changes generally work to increase directors' independence from shareholders' control, providing further evidence for the mediating hierarchy model. See Robert Daines & Michael Klausner, Value-Maximizing Charters: An Empirical Analysis of Antitakeover Provisions in Corporate Charters at the IPO Stage (Jan. 13, 1997) (unpublished manuscript, on file with the Virginia Law Review Association).

[91] See, e.g., sources cited supra notes 1, 15 (describing directors as shareholders' agents).

[92] Clark, supra note 17, at 56.

[93] Id.

[94] See Restatement (Second) of Agency § 385 (1958).

practical difficulties associated with shareholder voting.[95] Even if a firm's shareholders were to pass a *unanimous* resolution directing the board to pursue some course of action—say, declaring a dividend, or firing a particular executive—the board has no legal obligation to comply.[96] Shareholders can elect directors and, under some circumstances, remove them—but they cannot tell them what to do.

Because American law does not permit shareholders to command the board to action, describing directors as shareholders' "agents" grossly misrepresents at least the legal nature of their relationship. In the eyes of the law, corporate directors are a unique form of fiduciary who, to the extent they resemble any other form, perhaps most closely resemble trustees.[97] Like trustees, directors, once elected, become the ultimate decisionmaking authority within the firm, constrained primarily by their fiduciary duties. And like trustees—whom the law permits to represent beneficiaries with conflicting interests—directors are allowed free rein to consider and make trade-offs between the conflicting interests of different corporate constituencies. In other words, the prevailing academic wisdom that corporate law adheres to a shareholder primacy norm turns out to be mistaken. As we demonstrate below, American law in fact grants directors tremendous discretion to sacrifice shareholders' interests in favor of management, employees, and creditors, in deciding what is best for "the firm."[98]

This broad delegation of authority is both explained and supported by the mediating hierarchy model. If directors are to act as hierarchs, it is essential for them to hold the ultimate decisionmak-

[95] Cf. Gordon, supra note 8, at 353 (suggesting that the rule of directorial discretion can be explained as a response to the voting pathologies likely to plague shareholders whose interests are heterogeneous). In a sense, our mediating hierarchy model adopts Jeffrey Gordon's argument and takes it a step further by suggesting that directorial discretion responds to the voting and contracting pathologies likely to plague interactions among all of the firm's heterogenous stakeholders.

[96] See, e.g., Auer v. Dressel, 118 N.E.2d 590, 593 (N.Y. 1954) (holding that directors have no obligation to respond to shareholder resolution demanding reinstatement of dismissed officer).

[97] See DeMott, supra note 15, at 880 ("[D]irectors occupy a trustee-*like* position."). Unlike trustees, however, directors do not hold title to the corporation's property, which resides in the name of the legal entity itself. Shareholders similarly do not have title to any of the corporation's property.

[98] See infra text accompanying notes 123-62 (discussing balancing).

ing authority within the firm and to be allowed full discretion to represent competing interests. If the board were instead subject to the direct command and control of one or more of the corporation's constituencies, that constituency could use its power over the board to seek rents opportunistically from other members of the productive team, thus discouraging team-specific investment. Accordingly, giving directors ultimate control over the corporation's assets serves economic efficiency by allowing coalitions that hope to benefit from team production but fear that their gains will be squandered in rent-seeking squabbling to "tie their own hands" for their mutual advantage.

B. Corporate Personality and the Rules of Derivative Procedure

A second striking aspect of corporate law that supports the mediating hierarchy model is the convention that views a corporation as a "legal person." In the eyes of the law, filing articles of incorporation creates a new entity, separate from its promoters and shareholders.[99] This notion of legal personality carries significant legal and economic consequences. For example, the firm can hold title to property, and can thereby function as the repository of all "residual" income from team production that is not actually paid out to team members. Thus, the corporate entity itself can serve as the passive "budget breaker" Holmstrom argued is needed to solve the contracting dilemma he regarded as fundamental in team production.[100] As a practical matter, most public corporations do retain a substantial portion of the earnings left over after the firm's contractual obligations have been met rather than pay them out in the form of dividends to shareholders or bonuses to employees.[101]

The legal fiction of corporate personality also drives a central feature of corporate law known as the "derivative suit." In theory, corporate directors owe their fiduciary duties to the corporate personality: If a director violates her fiduciary duties, any claim brought must be brought by the corporation. But because a firm

[99] See, e.g., Del. Code Ann. tit. 8, § 106 (Supp. 1996).

[100] Supra text accompanying notes 40-46.

[101] See Eugene F. Fama & Harvey Babiak, Dividend Policy: An Empirical Analysis, 63 J. Am. Stat. Ass'n 1133, 1156 tbl.11 (1968) (finding from large sample of publicly-traded firms that median firm's dividend payout ratio ranged from 44% to 57% of profits, depending on assumptions.).

can only act through its human agents, occasions arise when the fiction of legal personality produces undesirable results. Problems typically arise when the board is asked to bring a claim in the firm's name for injury suffered at the hands of *the board itself*. The quandary created by asking directors to sue themselves has produced the derivative suit.

Under the derivative suit rules, when a majority of the board of directors charged with taking legal action on behalf of the firm has conflicting personal interests that may prevent it from adequately representing the firm's interests, a shareholder may, under very limited circumstances, be permitted to step into the shoes of the corporate entity and sue in its name and on its behalf.[102] Because derivative standing is normally limited to shareholders, on first inspection derivative actions can be read to imply that the law supports shareholder primacy.[103] A closer inspection of the legal rules applying to derivative suits suggests, however, that the procedure of granting shareholders standing to sue in derivative cases is designed primarily to serve the interests of the firm as a whole, rather than the interests of shareholders *per se*. In other words, shareholders are allowed to sue derivatively not just to protect shareholders, but to protect the interests of *all* the members of the coalition that comprises the firm.

We recognize that some may find the notion that directors owe their fiduciary duties to the firm, rather than its shareholders, to be controversial. In recent years, it has become common in both the legal and the economic literature for directors' fiduciary obligations to be described as being owed "to shareholders."[104] Yet case law makes clear that directors owe their fiduciary duties primarily *to the corporation itself*.[105] Although this duty to "the corporation"

[102] See, e.g., Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (derivative suit alleging breach of directors' duty of care). See generally Clark, supra note 8, at 639-64 (discussing derivative suits).

[103] For example, some commentators explain the derivative suit as a device to help shareholders overcome the free-rider effects that otherwise would discourage any individual shareholder from taking legal action that would benefit shareholders as a class. See, e.g., Clark, supra note 8, at 394-97.

[104] See, e.g., Brudney, supra note 1, at 1416 & n.33; Oliver Hart, An Economist's View of Fiduciary Duty, 43 U. Toronto L.J. 299, 303 (1993).

[105] See Restatement (Second) of Agency § 14C cmt. a (1958) (stating that directors owe duties to "the corporation itself rather than to the shareholders individually or collectively"). Some cases and commentators describe directors' fiduciary duties as

can perhaps be interpreted to mean a duty exclusively to the shareholders of the corporation, we agree with those who argue directors should be viewed as owing fiduciary duties to the corporation as a separate legal entity, apart from any duties they might also owe to shareholders.[106]

Several procedural aspects of derivative suits support this view. Most states, for example, require shareholders seeking to sue derivatively to first "demand" that the firm's board of directors take legal action on the firm's behalf; this demand requirement is excused only when the board is subject to conflicts of interest that are both obvious and substantial.[107] Moreover, even when demand is excused, a board may be able to take control of, and terminate, a shareholder-led derivative suit if an independent investigating committee of directors who are not subject to conflicts of interest so recommends.[108] Such procedural hurdles make it extremely difficult for shareholders to sue derivatively. They also insulate directors from shareholder challenge and control, in keeping with the mediating hierarchy model.

The law treats derivative suits filed on behalf of the corporation differently from shareholder suits claiming direct harm in other respects as well. Most importantly, if a derivative suit is successful,

running to the corporation and its shareholders. See, e.g., Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1988) ("It is basic to our law that the board of directors . . . owe[s] fiduciary duties of care and loyalty to the corporation and its shareholders."). Others describe these duties simply as owed to "the corporation," without mentioning shareholders explicitly. See, e.g., United Teachers Assocs. Ins. Co. v. MacKeen & Bailey, 99 F.3d 645, 650-51 (5th Cir. 1996) (stating that a director owes a fiduciary duty "to the corporation"). However, extensive case law authorizing directors to consider nonshareholder interests in deciding what is best for "the firm" makes clear that directors' duties are not limited to shareholders but are owed to the corporation generally. See infra text accompanying notes 111-15, 123-62; see also Demott, supra note 15, at 916-17 (noting that some cases state that the corporate entity itself owes a fiduciary duty to its shareholders and questioning how this is possible under an analysis that views the corporation's interests as identical to its shareholders').

[106] See, e.g., Steven M.H. Wallman, The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties, 21 Stetson L. Rev. 163 (1991).

[107] See Clark, supra note 8, at 640-43; see, e.g., Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984) (discussing demand requirement).

[108] See Clark, supra note 8, at 640-43; see, e.g., Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (discussing termination of derivative actions).

any damages recovered must go into the corporation's coffers.[109] This requirement that damages be paid directly to the firm and not to the suing shareholders seems difficult to explain under the norm of shareholder primacy. Once we are willing to view the corporation as a coalition of shareholders and other stakeholders who have made firm-specific investments, however, the requirement makes sense. If shareholders could be the direct recipients of damages payments in derivative cases, the net effect would be similar to a dividend payment: Shareholders as a group would become wealthier at the expense of the corporate entity. This sort of wealth transfer usually harms creditors, employees, and other stakeholders in the corporation. Creditors, for example, are harmed because draining cash from a firm whose liabilities remain unchanged increases the risk of insolvency, while management might prefer that the corporation keep its funds for reinvestment, to increase the prestige and perquisites associated with their positions. Thus, by requiring damages to be paid to the corporation, the rules of derivative procedure ensure that the benefits of a successful suit accrue to *all* the corporation's stakeholders. Shareholders can still take cash from the firm in the form of dividends, but only when the directors (the mediating hierarchy) declare they may do so.[110]

Finally, a third reason to believe that shareholder standing to sue derivatively is instrumental is that, under certain circumstances, the law grants other stakeholders in the firm standing to sue directors for breach of their fiduciary duty. Corporate law has long allowed bondholders and other creditors to bring claims of breach of fiduciary duty against the board once a corporation becomes insolvent.[111] More significantly, recent case law suggests that creditors may have standing to sue even *before* a corporation has reached the point of insolvency. In *Credit Lyonnais Bank Nederland, N.V.*

[109] See Clark, supra note 8, at 659. Litigation expenses and lawyer's fees incurred by the plaintiff shareholders in the course of a successful derivative action also must be paid by the corporation. See id. at 660-62.

[110] This analysis may help explain why boards generally choose to retain a large share of corporate earnings rather than paying them out in the form of dividends. See Fama & Babiak, supra note 101.

[111] See Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787-88 (Del. Ch. 1992) (holding that a board of directors owes fiduciary duties to creditors no later than when the corporation becomes insolvent).

v. Pathe Communications Corp.,[112] the board of directors of a still solvent corporation refused to undertake a high-risk strategy that was strongly favored by the firm's shareholders on the ground that the strategy harmed the firm's creditors. In upholding the board's refusal, the Delaware Chancery Court observed:

> [A] board of directors is not merely the agent of the residue [sic] risk bearers, but owes its duty to the corporate enterprise. . . . [I]n managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act. . . . [The board] had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.[113]

This language obviously reflects a judicial perception that directors' fiduciary duties to "the corporate enterprise" go beyond a simple duty to maximize shareholder wealth, and encompass the interests of a variety of other corporate constituencies. Thus, the opinion has been read to suggest that creditors may have standing to sue directors for breach of fiduciary duty even before a firm becomes insolvent—an idea that directly challenges shareholder primacy.[114] The *Credit Lyonnais* decision consequently has provoked an outpouring of academic commentary debating the opinion's meaning and merits.[115]

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[112] Civ. A. No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991).

[113] Id. at *108-09.

[114] See In re Buckhead America Corp., 178 B.R. 956, 968 (D. Del. 1994) (suggesting that creditors can derivatively sue directors who fail to promote their interests as called for by *Credit Lyonnais*).

[115] See, e.g., Laura Lin, Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors, 46 Vand. L. Rev. 1485 (1993); Lynn M. LoPucki & William Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. Pa. L. Rev. 669, 768-71 (1993); C. Robert Morris, Directors' Duties in Nearly Insolvent Corporations: A Comment on *Credit Lyonnais*, 19 J. Corp. L. 61 (1993); Steven L. Schwarcz, Rethinking a Corporation's Obligation to Creditors, 17 Cardozo L. Rev. 647 (1996); Royce de R. Barondes, Fiduciary Duties of Officers and Directors of Corporations Operating in the Vicinity of

When viewed through the lens of the mediating hierarchy model, however, *Credit Lyonnais* makes sense. As a general rule, the mediating hierarchy model of the corporation counsels against granting derivative standing to any group but shareholders. No director wants to find herself a defendant in a lawsuit, and if standing were widely available, various stakeholder interests—including managers, employees, and creditors—would be tempted to use the threat of suit to extract concessions from directors, opening the door to exactly the sort of rent-seeking among team members the mediating hierarchy is designed to prevent. Thus, while *someone* must be able to sue wayward directors derivatively, it is important to ensure that directors cannot be sued by all. And, for a variety of reasons we discuss later, in most cases shareholders are in the best position to ensure that derivative suits are brought only when doing so serves the interests of the corporate coalition as a whole.[116]

When a firm approaches insolvency, however, shareholders' interests can become a poor proxy for the corporate coalition's interests. So long as a firm is struggling to make ends meet, shareholders are unlikely to enjoy any benefits from stock ownership in the form of either dividends or stock price appreciation. Thus, as in the *Credit Lyonnais* case, shareholders may favor high-risk strategies that substantially increase the risk of insolvency on the theory that if the firm is tipped into bankruptcy, they have not lost much, while if the strategy succeeds they may reap a profit. Yet insolvency can impose terrible costs on other members of the corporate coalition—in particular, employees and creditors—who stand to lose all or part of their firm-specific investment. Thus, shifting derivative standing from shareholders to creditors at the point of insolvency, or even before, may be the best strategy to ensure that derivative suits are used to the best advantage of the coalition of interests that makes up the corporation.

Insolvency (July 1997) (unpublished manuscript, on file with the Virginia Law Review Association).

[116] See infra Section II.C (discussing how shareholders can only bring claims against directors for breach of fiduciary duty in circumstances where directors' actions have harmed all the members of the corporate coalition, not just shareholders' interests); see also infra Section II.D (discussing how shareholder voting rights may serve the corporate coalition as a whole, both because shareholders are less likely to use their votes for rent-seeking and because shareholders' interest in maximizing share price is often in harmony with other stakeholders' interests).

C. The Substance of Directors' Fiduciary Duties

The preceding analysis of derivative suit procedure and standing suggests that corporate law permits shareholders to bring derivative suits primarily to protect the interests of the corporate entity, rather than the interests of shareholders alone. Once we move beyond procedure to look at the substance of derivative suits—the rules that define the fiduciary duties derivative suits seek to enforce—it becomes even more clear that these suits serve "the firm" rather than its shareholders. A survey of cases where directors have been charged with breach of fiduciary duty reveals a curious pattern: *Corporate law only permits shareholders to bring successful derivative claims against directors in circumstances where bringing such claims benefits not only shareholders, but other stakeholders in the coalition as well*.

This pattern comes into sharp relief in examining the very limited factual circumstances under which directors can be sued successfully for breach of fiduciary duty. As we explore further below, case law generally divides directors' fiduciary duties into two forms: the duty of loyalty, and the duty of care.[117] In both cases, directors generally will be subject to liability only for conduct that harms not just shareholders, but the corporate coalition as a whole.

1. The Duty of Loyalty

Although on first inspection, the idea of a "duty of loyalty" sounds rather broad, in practice, American law has interpreted the duty quite narrowly. Indeed, case law has held directors liable for breach of the duty of loyalty only in two sorts of situations. The first involves self-dealing of the most obvious and egregious kind, as when a director enters into a transaction with a firm in her personal capacity or through a business entity she owns and controls.[118]

[117] See Clark, supra note 8, at 123-40 (care), 141-57 (loyalty).

[118] In fear that such transactions may unreasonably favor the director's interests at the corporation's expense, corporate law deems a self-dealing transaction voidable at the firm's option unless the director can establish both that she made full and fair disclosure of her personal interest in the deal, and that the terms of the transaction were either approved by a majority of the disinterested members of the board of directors, or were arms length and intrinsically fair. See, e.g., Del. Code Ann. tit. 8, § 144 (1974 & Supp. 1996). See generally Clark, supra note 8, at 159-89 (describing rules of "basic self-dealing").

The second context involves directors taking a "corporate opportunity" by reaping profits from personal business ventures that either are in the same line of business as the firm's, or became available to them because of their corporate position.[119]

Despite its narrow focus, the duty of loyalty has teeth, and sets important substantive limits on directors' behavior. Nevertheless, the duty applies to only a very limited subset of all the possible situations where directors might use their corporate powers to serve their own interests. Most obviously, the duty of loyalty does not apply in circumstances where directors make strategic business decisions that provide *nonmonetary* benefits to themselves at shareholders' expense, a category Clark has labeled "corporate action with mixed motives."[120] Thus directors do not breach their duty of loyalty when they use firm funds to build a lavish headquarters, or to make donations to their favorite charities.

In the next Section we will return to reconsider this peculiar limitation of the duty of loyalty. For the moment, we observe that case law on the duty of loyalty appears consistent with the mediating hierarchy model we are espousing. This is because the duty of loyalty, as conventionally and narrowly defined, protects employees, creditors, and other stakeholders just as much as it protects shareholders. After all, when directors use their corporate position to steal money from the firm, every member of the coalition suffers. Allowing shareholders to sue derivatively in loyalty cases thus conforms to the mediating hierarchy model by benefitting all who make up the corporate "team."

2. The Duty of Care, the Business Judgment Rule, and the Best Interests of "The Corporation"

In addition to the duty of loyalty, corporate directors, in theory, owe their firms a duty of care.[121] We say "in theory" because, while the idea of a duty to be careful at first appears to impose significant constraints on directors, in practice the duty of care is all but eviscerated by a legal doctrine known as the "business judgment

[119] See, e.g., Broz v. Cellular Info. Sys., 673 A.2d 148, 149 (Del. 1996). See generally Clark, supra note 8, at 223-62 (describing corporate opportunity doctrine).

[120] Clark, supra note 8, at 142.

[121] See Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (finding breach of duty of care). See generally Clark, supra note 8, at 123-40 (discussing duty of care).

rule."[122] Because this doctrine seriously undermines directors' accountability to shareholders by virtually insulating directors from claims of lack of care, it seems inconsistent with the view that directors are shareholders' agents. The mediating hierarchy model we propose, however, suggests that the business judgment rule may serve an important economic function. In particular, the rule may help prevent coalition members (and especially shareholders) from using lawsuits as strategic devices to extract rents from the coalition. This is because the business judgment rule works to ensure that directors can only be found liable for breach of the duty of care in circumstances where a finding of liability serves the collective interests of all the firm's members.[123]

To earn the protection of the business judgment rule, directors must show that a challenged decision satisfied three requirements: (1) The decision was made "on an informed basis"; (2) the directors acted "in good faith"; and (3) the directors acted "in the honest belief that the action taken was in the best interests of the company."[124] Although a requirement that directors inform themselves[125] before taking action obviously benefits shareholders, it also seems likely to benefit employees, creditors, and other stakeholders. Similarly, while case law provides little guidance on what if anything the requirement of "good faith" adds to the existing duty of loyalty, "bad faith" seems likely to pose a threat to all who contribute to the coalition known as the firm.

Most importantly, however, the business judgment rule also requires directors to demonstrate that they honestly believed they were acting in the best interests of "the company." It is this third prong that most clearly suggests that American law views the corporation as an entity with interests of its own, and not just a proxy

[122] See *Van Gorkom*, 488 A.2d at 872 (discussing business judgment rule); Clark, supra note 8, at 123-25 (same).

[123] In many states, the business judgment rule has been further strengthened by statutory provisions that permit corporate charters to restrict director liability even further. See, e.g., Del. Code Ann. tit. 8, § 102(b)(7) (1974 & Supp. 1996) (permitting corporate charter to include provision that eliminates directors' personal liability to corporation for breaches of duty of care).

[124] *Van Gorkom*, 488 A.2d at 872 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

[125] Case law has interpreted this requirement to demand that directors "inform[] themselves . . . 'of all material information reasonably available to them.'" Id. (quoting *Aronson*, 473 A.2d at 812).

for shareholders' interests. This is because *case law generally interprets the "best interest of the company" to include nonshareholder interests, including those of employees, creditors, and the community.*[126]

Commentators who take shareholder primacy as a given may be inclined to view this claim with suspicion. Indeed, a number of nineteenth- and early twentieth-century cases appear to support the shareholder primacy norm by limiting directors' abilities to consider nonshareholder interests.[127] The 1919 decision in *Dodge v. Ford Motor Co.*[128] is one of the most frequently cited cases in support of the shareholder primacy view.[129] In that case the Dodge brothers, minority shareholders of Ford Motor Company, sought to compel the highly profitable company to pay out a large dividend. The board of directors resisted, largely in response to Henry Ford's demand that the company's huge profits be used to create more jobs by expanding production and to benefit consumers by reducing Ford's car prices. The Michigan Supreme Court's opinion came down firmly on the side of shareholder primacy, declaring that "[a] business corporation is organized and carried on primarily for the profit of the stockholders."[130]

As a number of scholars have pointed out, however, *Dodge v. Ford Motor Co.* was a highly unusual case.[131] The Dodge brothers wanted cash dividends from Ford in order to start a competing business, and there was strong evidence of Henry Ford's hostility toward them as potential competitors.[132] Accordingly, Ford's unapologetic claim that he wanted to retain cash to benefit other stakeholders may have been simply a provocative red herring. The real tension in the case may not have been between shareholders

[126] See infra notes 140-48 and accompanying text.

[127] Older case law appears to have equated shareholders with partners in a partnership, and so sometimes describes shareholders as having a joint "ownership" interest in the corporation's property. See Koehler v. Black River Falls Iron Co., 67 U.S. (2 Black) 715 (1862) (holding that directors are obligated to execute their "trust" not for their own benefit, but for the common benefit of the stockholders of the corporation).

[128] 170 N.W. 668 (Mich. 1919).

[129] See Smith, supra note 15, at 315.

[130] *Dodge*, 170 N.W. at 684.

[131] See, e.g., Mitchell, supra note 16, at 601-02.

[132] The courts may also have been concerned about the antitrust implications of Ford's preventing the Dodge brothers from competing with him. See generally Jesse H. Choper et al., Cases and Materials on Corporations Law 994-95 (3d ed. 1989) (discussing case background); Clark, supra note 8, at 602-04 (same).

and stakeholders, but between two groups of shareholders. The latter possibility is especially important because the Ford Motor Company was, at the time, a closely held corporation.[133] Shareholders in close corporations typically act not just as investors but also as managers involved in the day-to-day operations of the firm.[134] As a result, shareholders in close corporations are often tempted to use their managerial powers opportunistically to exploit their fellow shareholders, with whom their interests are frequently in conflict.[135] To address this problem, the law of close corporations calls for heightened fiduciary duties that run not from directors to the firm, but from *shareholder to shareholder*.[136] Thus, the decision in *Dodge v. Ford Motor Co.* is most accurately construed as a statement about the special duties shareholders owe each other in closely held corporations, not about the relationship between shareholders and other stakeholders in a corporation.[137]

More importantly, even if *Dodge v. Ford Motor Co.* applied to public corporations, case law has evolved significantly since 1919, and in a direction that disfavors the shareholder primacy view. As early as the 1930s the conflict between shareholder primacy and the emerging stakeholder perspective was highlighted in a famous debate in the *Harvard Law Review* between two prominent legal

[133] See Clark, supra note 8, at 602-03.

[134] Id. at 762.

[135] In contrast, the passive investors who own stock in public corporations tend to share homogeneous interests—in particular, an interest in maximizing the market price of their shares. See infra text accompanying note 175 (discussing public shareholder homogeneity).

[136] See generally Clark, supra note 8, at 798-800 (describing shareholders' fiduciary duties to other shareholders in a close corporation). As a general rule, shareholders in close corporations who want to reduce inter-shareholder conflict by creating a mediating hierarchy cannot rely on the device of an independent board of directors when a single shareholder or coalition of shareholders owns a controlling block of shares that carries the unilateral power to select the board. Although this problem can be addressed through cumulative voting arrangements and the like, directors elected under such procedures would function less like disinterested trustees and more like representatives in a legislature who are expected to vigorously defend the interests of the particular constituents who elect them.

[137] See Smith, supra note 15, at 286, 315 (concluding that the shareholder primacy norm articulated in *Dodge v. Ford Motor Co.* is linked to minority shareholder oppression in close corporations and that the business judgment rule makes shareholder primacy "virtually unenforceable" in public corporations).

scholars, Adolf Berle and E. Merrick Dodd.[138] By the 1950s, Berle was ready to concede that, as a matter of law, "[corporate] powers [are] held in trust for the entire community."[139] Berle's retreat is supported by a series of mid- and late-twentieth-century cases that have allowed directors to sacrifice shareholders' profits to stakeholders' interests when necessary for the best interest of "the corporation." Thus judges have sanctioned directors' decisions to use corporate funds for charitable purposes;[140] to reject business strategies that would increase profits at the expense of the local community;[141] to avoid risky undertakings that would benefit shareholders at creditors' expense;[142] and to fend off a hostile takeover bid at a premium price in order to protect the interests of employees or the community.[143] As these examples illustrate, modern corporate law does not adhere to the norm of shareholder primacy. To the contrary, *case law interpreting the business judgment rule often explicitly authorizes directors to sacrifice shareholders' interests to protect other constituencies.*[144]

[138] See A.A. Berle, Jr., Corporate Powers as Powers in Trust, 44 Harv. L. Rev. 1049 (1931); E. Merrick Dodd, Jr., For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145 (1932). Dodd argued that

> it is undoubtedly the traditional view that a corporation is an association of stockholders formed for their private gain and to be managed by its board of directors solely with that end in view . . . [however,] public opinion, which ultimately makes law, has made and is today making substantial strides in the direction of a view of the business corporation as an economic institution which has a social service as well as a profit-making function.

Id. at 1146-48. Dodd went on to suggest that "[t]here is a widespread and growing feeling that industry owes to its employees not merely the negative duties of refraining from overworking or injuring them, but the affirmative duty of providing them so far as possible with economic security," id. at 1151, and that such views suggest another view of the corporation not as an aggregate of stockholders but "'a body which . . . from the very nature of things differs from the individuals of whom it is constituted.'" Id. at 1160 (quoting Albert Venn Dicey, Law and Public Opinion in England 165 (3d ed. 1920).

[139] Adolf A. Berle, Jr., The 20th Century Capitalist Revolution 169 (1954) ("The argument has been settled (at least for the time being) squarely in favor of Professor Dodd's contention.").

[140] See, e.g., Theodora Holding Corp. v. Henderson, 257 A.2d 398 (Del. Ch. 1969).

[141] See, e.g., Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 1968).

[142] See, e.g., Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., Civ. A. No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991).

[143] See cases cited infra note 146.

[144] In addition, "corporate constituency" statutes in 28 states now explicitly authorize directors to consider nonshareholder interests, at least in the context of takeover

Some legal commentators and some cases explain this approach as being in shareholders' interests in the "long run."[145] This explanation makes little sense, however, under a grand-design principal-agent model that views shareholders' interests as meaning the interests of the shareholders of the particular firm whose directors are at that moment favoring other constituencies. Consider, for example, the common scenario in which a court upholds a board's discretion to reject a takeover bid at a substantial premium in order to protect the interests of the firm's employees or the community.[146] How can rejecting a premium offer benefit the long-run interests of the present pool of shareholders if—as modern financial theory holds—today's lower market price reflects the best possible estimate of those shareholders' future returns under current management?[147]

In contrast, the mediating hierarchy model predicts that shareholders benefit from granting directors discretion to favor other constituencies, because it suggests that shareholders' "long-run interest" should be interpreted to mean the long-run interests of *all* the shareholders who hold, have held, or will hold stock in the firm, including those original investors who bought their shares when the

threats. See Mitchell, supra note 16, at 579 n.1, 587-88 n.33 (listing statutes). See generally Eric W. Orts, Beyond Shareholders: Interpreting Corporate Constituency Statutes, 61 Geo. Wash. L. Rev. 14 (1992) (discussing the debate over interpretations of corporate constituency statutes).

145 Clark, supra note 8, at 681-84; John C. Coates IV, Note, State Takeover Statutes and Corporate Theory: The Revival of an Old Debate, 64 N.Y.U. L. Rev. 806, 832-33 (1989).

146 See, e.g., Cheff v. Mathes, 199 A.2d 548 (Del. 1964) (describing how directors of Holland Furnace Company fended off hostile acquirer in part to protect employees); Paramount Communications v. Time, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) & 94,514 (Del. Ch. 1989) (describing how directors of Time rejected Paramount's premium offer in order to pursue merger that would preserve "Time culture" of journalistic integrity).

147 See Coates, supra note 145, at 841-42 (describing finance-based critique of long-run argument). See generally Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 287-310 (4th ed. 1991) (describing modern portfolio theory). One can, perhaps, justify granting directors' discretion to reject a premium bid under the norm of shareholder primacy by arguing that the market price seriously underestimates the actual value of the firm, and that, although this is known to the directors, they are somehow unable to communicate the fact to shareholders or the market generally. Although this scenario seems unlikely under standard financial theory, Lynn Stout has argued at length elsewhere that an elaboration of standard theory that incorporates the possibility that investors may have heterogeneous expectations provides theoretical support for the claim that the market price of a firm's stock may be "too low." Lynn A. Stout, Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law, 99 Yale L.J. 1235 (1990).

firm first went public. Opportunistically exploiting the firm-specific investments of corporate stakeholders (say, violating employees' expectations of job security by moving the firm's manufacturing plants to Mexico) may well benefit, in both the short and the long run, those individuals who happen to hold shares in the corporation at the time the decision to move is made. If the firm's employees anticipated this sort of conduct ex ante, however, they might well have demanded higher wages—or been more reluctant to invest in firm-specific human capital—in earlier years.

The mediating hierarchy model thus lends intellectual content to the argument that treating directors as trustees charged with serving interests above and beyond those of shareholders in fact can be in shareholders' "long-run interests," because a shareholder decision to yield control rights over the firm to directors ex ante—that is, when the corporate coalition is first formed—can induce other participants in the team production process to make the kind of firm-specific investments necessary to reap a surplus from team production in the first place.[148] Thus, a broad interpretation of the business judgment rule that permits directors to sacrifice shareholders' interests to those of other corporate constituencies "ties the hands" of shareholders in public corporations in a fashion that ultimately serves their interests as a class, as well as those of the other members of the corporate coalition.

3. Director Adoption of Takeover Defenses and Other "Mixed Motive" Cases

The discussion above suggests that case law extending the business judgment rule to situations where directors opt to sacrifice shareholders' returns for other constituencies fits neatly within the mediating hierarchy model of the firm, which views directors as a form of third-party trustee charged with balancing the competing

[148] A similar argument has been made by Andrei Shleifer and Lawrence Summers, who have suggested that shareholders as a class may suffer from inefficient "reputational externalities" if the shareholders of one firm opportunistically exploit their stakeholders' firm-specific investments, causing stakeholders at other firms to become more reluctant to make firm-specific investments. Andrei Shleifer & Lawrence H. Summers, Breach of Trust in Hostile Takeovers, *in* Corporate Takeovers: Causes and Consequences 33, 45-46 (Alan J. Auerbach ed., 1988).

interests of the many stakeholders who comprise the firm. The mediating hierarchy model also may offer a potential explanation for another interesting aspect of corporate law that has puzzled commentators: why courts apply the protections of the business judgment rule—not the far more restrictive loyalty analysis—to "mixed motive" cases where directors appear to be using their corporate powers not to benefit the firm, but to benefit *themselves*.[149]

Because the duty of loyalty limits obvious self-dealing or takings of corporate opportunities, corporate law makes it difficult for directors to extract any monetary gain from their position with the firm beyond their agreed-upon compensation. However, this narrow interpretation of the duty of loyalty ignores the obvious reality that directors often can use their corporate powers to provide themselves with *nonmonetary* benefits, such as an increase in their own authority, security of position, and quality of life. For example, directors may decide to retain corporate earnings and build empires instead of paying shareholders dividends; to avoid risky ventures even when accepting risk might substantially increase the firm's expected profits; to resist hostile takeovers even at premium prices; and to choose the "quiet life" over a hard-nosed approach of confrontations and conflicts with bondholders, employees, and community leaders.[150]

Courts generally decline to treat these sorts of cases as loyalty issues and instead apply the liberal business judgment rule to such actions.[151] This judicial tolerance is hard to reconcile with a shareholder primacy norm. The mediating hierarchy model, however, helps explain why corporate law declines to intervene in directors' decisions, even in these mixed motive cases. The reason is that *the pursuit of directors' nonmonetary interests in mixed motive situations often benefits other stakeholders in the firm, even as it harms shareholders.*

Consider the example of a board's decision to reduce the volatility of a firm's earnings by acquiring an unrelated business or by us-

[149] See supra text accompanying note 120 (discussing mixed motive cases).

[150] See Randall Mørck et al., Characteristics of Targets of Hostile and Friendly Takeovers, *in* Corporate Takeovers: Causes and Consequences, supra note 148, at 101 (describing typical director practices that may reduce shareholders' wealth).

[151] See supra text accompanying notes 118-20 (discussing limited scope of duty of loyalty).

ing derivatives for hedging. Modern portfolio theory teaches that reducing such firm-specific or unique risk does not benefit diversified shareholders.[152] Reducing unique risk does, however, benefit *directors* by decreasing the likelihood that their firm will become insolvent and they themselves might lose their positions.[153] Yet, in addition to benefitting directors, reducing unique risk *also* benefits other corporate constituents—including managers, rank-and-file employees, and creditors—who have a stronger interest than the shareholders do in ensuring that the firm remains solvent.

A second example arises where a board chooses "the quiet life" by granting concessions to labor unions or creditors. While such a strategy obviously is contrary to shareholders' interests, it just as obviously benefits other members of the coalition that make up the firm. Thus, a broad interpretation of the business judgment rule that permits directors to sacrifice shareholder wealth in this fashion again may serve the interests of the corporate coalition even though it allows directors to serve their own nonmonetary interests. The evident unwillingness of judges to second-guess directors' decisions even in such cases is strong evidence that corporate law protects directors' discretion to favor nonshareholder constituencies, even when directors may abuse this discretion to serve themselves.

Perhaps the most interesting example of the law's tolerance for director actions with mixed motives can be found in case law applying the business judgment rule to a board's decision to fight off a hostile takeover bid at a premium price. A board's decision to resist a hostile offer often can protect the expectations of the firm's employees, creditors, managers, or other team members who have made firm-specific investments, especially when the bidder appears poised to alter the structure of the firm by downsizing, recapitalizing, or simply replacing existing management. At the same time, because a takeover also threatens the principal benefit directors reap from being directors (their positions on the board), this situation presents the potential for conflict not only between the board and the shareholders, but between the board and other stakeholders as well.

[152] See Brealey & Myers, supra note 147, at 137-39.

[153] See Henry T.C. Hu, Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective, 73 Tex. L. Rev. 985, 1016-17 (1995). See generally Brealey & Myers, supra note 147, at 137-39 (discussing unique risk).

Interestingly, Delaware courts have modified the business judgment rule in takeover situations, in recognition of this threat of directorial self-interest. In the landmark 1985 case of *Unocal Corp. v. Mesa Petroleum Co.*,[154] the Delaware Supreme Court held that directors of public corporations who wish to resist a hostile takeover bid cannot claim the protection of the business judgment rule unless they first demonstrate that the proposed takeover poses a threat to the "corporation."[155] The *Unocal* decision also made clear, however, that in deciding whether there is a threat to the corporate entity, the directors of the corporation are invited to consider "the impact on . . . creditors, customers, employees, and perhaps even the community generally."[156] In other words, *Unocal* squarely rejects shareholder primacy in favor of the view that the interests of the "corporation" include the interests of nonshareholder constituencies.[157]

Unocal's reformulation of the business judgment rule in the takeover context is itself subject to an exemption that provides intriguing—if tentative—evidence in favor of the mediating hierarchy model. Less than a year after deciding *Unocal*, the Delaware Supreme Court was again called upon to apply the business judgment rule in a takeover context in the case of *Revlon, Inc. v. MacAndrews & Forbes Holdings.*[158] In that case, the directors of Revlon corporation adopted defensive strategies that favored a friendly bidder over a hostile bidder, citing in part a desire to protect the interests of certain creditors of the firm. The Delaware Supreme Court held that the directors had violated the business judgment rule because when "break-up of the company was inevitable . . . [t]he duty of the board . . . changed from the preservation

[154] 493 A.2d 946 (Del. 1985). Directors are also required to show that any defensive measures they adopt to discourage the takeover bid are "reasonable in relation to the threat posed." Id. at 955.

[155] Id. at 954-55.

[156] Id. at 955.

[157] In a subsequent case, the Delaware Supreme Court suggested that directors could consider other constituencies' interests only when doing so ultimately provided some benefit to shareholders as well. Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 176 (Del. 1986). The team production model explains how sacrificing shareholders' interests to stakeholders' can sometimes serve the interests of both groups in the long run. See supra text accompanying notes 145-48 (describing how director discretion serves shareholders' interests).

[158] 506 A.2d 173 (Del. 1986).

of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit."[159] Thus, the court held that "[t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[160]

On first inspection, this language appears to support shareholder primacy. Closer analysis suggests, however, that *Revlon* may in fact support the mediating hierarchy model. Although the *Revlon* opinion did not clarify what it meant to say that a company's "break-up" was "inevitable," in subsequent cases *Revlon* has been interpreted to apply "[w]hen a majority of a corporation's voting shares are [to be] acquired by a single person or entity, or by a cohesive group acting together."[161] In other words, *Revlon* applies when a formerly publicly held corporation is about to become essentially a *privately held* firm. As noted earlier, in closely held firms subject to the control of a single shareholder or group of shareholders, directors enjoy relatively little independence and can no longer function effectively as mediating hierarchs.[162] Thus the *Revlon* exception to the general rule may reflect an intuitive judicial recognition that when a firm "goes private," it abandons the mediating hierarchy approach in favor of a grand-design principal-agent structure dominated by a controlling shareholder.

D. Reexamining Shareholders' Voting Rights

Our analysis of the nature of directors' fiduciary duties and the rules of derivative suit procedure produces an interesting observation: Shareholders in public corporations generally can sue successfully in the firm's name only in situations where bringing suit benefits not only the shareholders, but the other stakeholders in the coalition as well. This curious result supports the mediating hierarchy

[159] Id. at 182.

[160] Id.

[161] Paramount Communications v. QVC Network, 637 A.2d 34, 42 (Del. 1994). Compare Black & Decker Corp. v. American Standard, 682 F. Supp. 772 (D. Del. 1988) (holding that *Revlon* applies to a recapitalization in which management's share of ownership would increase from 5% to 55%), with Paramount Communications v. Time, Inc., 571 A.2d 1140 (Del. 1989) (holding that *Revlon* does not apply to a merger between two publicly held entities where the surviving corporation would also be publicly held).

[162] See supra text accompanying notes 72-75.

model of the public corporation over the grand-design principal-agent approach. Before accepting the mediating hierarchy model as a superior alternative to the principal-agent approach, however, we need to address shareholder voting rights, an aspect of corporate law that initially appears to support the shareholder primacy claim.

Shareholders in public corporations enjoy voting rights in two areas. First, shareholders have the right to elect (and sometimes remove) the members of the board of directors.[163] Second, shareholders also enjoy the right to vote on certain "fundamental" corporate changes.[164] On first inspection, these rights seem to grant shareholders a much greater measure of control over how the firm is run than other members of the coalition enjoy. In both theory and practice, however, shareholders' voting rights—at least in publicly-traded corporations—are so weak as to be virtually meaningless. The nominal existence of shareholder voting rights consequently does not pose a serious challenge to the mediating hierarchy model. In the vast majority of cases, shareholders' voting rights give them little or no control over directors, who remain free to balance the interests of, and allocate rewards among, the various groups that constitute the firm.

Let us first consider shareholders' right to elect and remove directors. In small, closely held firms, or in firms where a single stockholder or group of stockholders controls the majority of shares, voting may give a majority stockholder significant power to select the members of the board and to exercise influence over them while they are in office.[165] In a typical publicly held firm with widely dispersed share ownership, however, legal and practical obstacles to shareholder action render voting rights almost meaningless. Most obviously, and as was first pointed out by Berle and Means, free-rider problems tend to inspire "rational apathy" among shareholders that leads them to "vote for whomever and whatever management recommends."[166] This tendency for share-

[163] See generally Del. Code Ann. tit. 8, §§ 141(k), 216(3), 223 (1974 & Supp. 1996) (describing shareholders' rights to elect and remove directors).

[164] See generally Del. Code Ann. tit. 8, §§ 109, 242, 251, 271 (1974 & Supp. 1996) (describing shareholders' right to vote on mergers, asset sales, and charter and bylaw changes).

[165] It should be noted that even in such firms, other constituencies, especially management, generally have considerable influence in practice over the choice of directors.

[166] Clark, supra note 8, at 94.

holders to follow management's lead is amplified by legal rules that grant directors authority to set the date for certain elections, nominate candidates for the board, and use corporate funds to solicit proxy votes from shareholders who do not plan to attend the shareholders' meeting (usually the overwhelming majority).[167] The net result is that shareholders in public corporations do not in any realistic sense elect boards. Rather, *boards elect themselves.* Once elected, moreover, directors almost always get to serve a full term free of shareholder control. Although shareholders can sometimes try to remove directors, the removal process is difficult at best, and subject to the same proxy rules and collective action problems.[168]

Shareholders' rights to vote on "fundamental" corporate changes also appear to be something of a fig leaf. Most states define very narrowly the categories of transactions on which shareholders are entitled to vote, including only statutory mergers, charter and bylaw amendments, and sales of substantially all assets.[169] With the exception of shareholders' right to vote to change bylaws, these voting rights are essentially veto rights: Shareholders cannot initiate fundamental changes, but can only vote "yes" or "no" if the board proposes them.[170] Thus, because there is usually more than

[167] See generally id. at 358 (describing shareholder meetings), 366-74 (describing proxy process).

[168] Shareholder attempts to remove directors may face additional hurdles if the relevant corporate statute does not grant shareholders the right to call special meetings, see, e.g., Del. Code Ann. tit. 8, § 211(d) (1974 & Supp. 1996) (directors or persons specified in the charter may call special meetings); if the relevant law or the corporation's charter requires shareholders to "show cause" for removal, see, e.g., id. § 141(k) (charter may include "for cause" provision); and if judicially created directorial rights to notice and hearing exist, see, e.g., Campbell v. Loew's, Inc., 134 A.2d 852, 859 (Del Ch. 1957) (stating that directors are entitled to notice and hearing before removal vote).

[169] See, e.g., Del. Code Ann. tit. 8, §§ 109, 242, 251, 271 (1974 & Supp. 1996) (describing which corporate changes trigger shareholder voting).

[170] See id. (describing shareholder voting rights). Because shareholders can initiate changes in the corporation's bylaws, rather than simply veto changes proposed by the directors, shareholders' rights to vote on bylaws in theory offer shareholders some possibility of being able to dictate corporate policy to directors. See Stewart J. Schwab & Randall S. Thomas, Realigning Corporate Governance: Shareholder Activism by Labor Unions, 96 Mich. L. Rev. 1018, 1055-56 (1998). Thus shareholders in recent years have attempted with mixed success to use their power to amend bylaws to force boards of directors to redeem poison pills. See id. at 1056-58 (describing one such case in Oklahoma); Jeffrey N. Gordon, "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett, 19 Cardozo L. Rev. 511, 544-46 (1997) (describing the same Oklahoma case as well as a

one way to skin the corporate cat, directors often can restructure transactions to achieve their desired end without triggering a shareholder vote.[171] Moreover, even when shareholders are entitled to vote, as in the case of director elections, the board still controls the proxy process, and shareholders still face collective action problems. The net result is that it is always extremely difficult, and often impossible, for shareholders to use their rights to vote on fundamental changes to oppose a transaction or policy the board favors.

This analysis inevitably raises the question: Why does corporate law provide for shareholder voting rights at all? As Clark has noted, a cynic who adheres to the norm of shareholder primacy may be tempted to conclude that shareholder voting is "a fraud[] or a mere ceremony designed to give a veneer of legitimacy to managerial power."[172] An alternative explanation, however, is that voting rights that do not give shareholders much power in the typical situation where a firm is being run less than perfectly can still play an important role in cases of flagrant malfeasance. Thus, for example, shareholders may refuse to approve a merger at a grossly inadequate price. Alternatively, a large shareholder or group of shareholders might launch a proxy battle to replace a nonperforming board, or simply sell their shares in the "market for corporate control" to a buyer who is willing to pay a high enough price.[173]

Recognizing that shareholder voting rights can act as a safety net to protect against extreme misconduct poses something of a problem for the mediating hierarchy approach, as it suggests that shareholders enjoy more control over how the firm is run than do other members of the coalition. Nevertheless, we believe that shareholder voting rights can be reconciled with the mediating hierarchy model under two theories.

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similar case in Georgia). Nevertheless, commentators have concluded that "[a]t some point . . . this broad shareholder power to adopt or amend corporate bylaws must yield to the board's authority to manage the business and affairs of the corporation." Schwab & Thomas, supra, at 1056; see also Gordon, supra, at 547-48 (discussing uncertainty of the law and desirability of limiting shareholders' right to interfere with board's "discrete business decisions").

171 See, e.g., Paramount Communications v. Time, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) & 94,514 (Del. Ch. 1989) (describing how directors of Time who wanted to pursue merger with Warner Communications restructured a deal to avoid triggering Time shareholders' voting rights).

172 Clark, supra note 8, at 95.

173 Id. at 464-78.

The first theory echoes our earlier arguments about the instrumental nature of shareholders' right to sue directors derivatively for breach of fiduciary duties owed to the firm.[174] That is, it seems possible that corporate law grants shareholders limited voting rights not just because the rights benefit shareholders, but because they serve the interests of other stakeholders in the firm as well. Thus, for example, it can be argued that shareholder election of directors may well serve the interests of all the firm's stakeholders. *Someone* must choose the directors, and for at least two reasons shareholders generally may be in the best position to do so in a way that serves the interests of all the members of the corporate coalition. The first reason is that plurality voting by shareholders who have a relatively homogeneous interest in maximizing share value may exhibit fewer pathologies and be less conducive to rent-seeking than a vote taken among many competing constituencies with conflicting interests.[175] (Imagine the chaos and politicking likely to attend an election in which a firm's creditors, executives, rank-and-file employees, and other stakeholders with unique and often conflicting interests could vote on their favored candidates.) The second reason is that the principal criterion shareholders are likely to apply in electing directors is maximizing the market value of their shares. Maximizing the value of a firm's stock can benefit not just shareholders but other stakeholders in the firm as well, at least when directors can pursue this goal by retaining and reinvesting corporate earnings rather than paying them out as dividends to

[174] See supra Section II.B.

[175] Gordon has explored this possibility in some detail, arguing that management by a board of directors serves shareholders' interests because shareholder voting is plagued by rent-seeking and other "public choice" problems when shareholders have heterogeneous views about how to run the company or differing preference about outcomes. See Gordon, supra note 8, at 359-74 (reviewing pathologies that can plague shareholder voting). But see supra text accompanying notes 95-96 (arguing that Gordon's analysis does not explain why directors can ignore even a unanimous shareholder resolution). Our argument essentially extends Gordon's analysis to the even more obvious case of voting involving all the stakeholders in the corporate coalition. See also Henry Hansmann, The Ownership of Enterprise (1996) (discussing the need for ownership rights to be held by individuals whose interests are relatively homogenous in order to avoid voting pathologies).

shareholders.[176] Thus, share value can sometimes be a proxy for, or an indicator of, the total value of rents being generated by the corporation.[177] Not a perfect proxy, we believe, but at least it is one legitimate indicator.[178]

A second possible way to reconcile shareholder voting rights with the mediating hierarchy model may be to interpret those rights as partial compensation for shareholders' unique vulnerabilities. Unlike executives, creditors, and other stakeholders who enter express contracts with the firm or at least interact regularly with its representatives, and who hence have other opportunities to influence the distribution of firm rents, shareholders rarely have the opportunity to negotiate directly with the firm for advantages. Because they are not involved in the corporation's day-to-day activities, they also have relatively little access to information about how the firm is being run and few opportunities to express their desires directly to the board of directors and top management.[179] Finally, because their numbers are usually greater than other constituents' and their individual interests often smaller, shareholders face even greater obstacles to collective action.

[176] Retaining earnings benefits creditors and employees by reducing the risk that the firm might become insolvent and may also serve the interests of upper management by increasing the prestige and power of their positions.

[177] See Lin, supra note 115, at 1497 (arguing that when a corporation is "financially sound, profit maximization benefits all participants in the corporate venture and promotes societal welfare").

[178] Maximizing share value is equivalent to maximizing total value if, as is often assumed, shareholders are the only "residual claimants" to all the firm's earnings after employees and other creditors have been paid. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J.L. & Econ. 395, 403-06 (1983) (arguing that "shareholders are the residual claimants to the firm's income," and that this explains why only shareholders enjoy voting rights). However, Margaret Blair has argued at length elsewhere that because other corporate stakeholders make firm-specific investments and because these cannot always be protected through explicit contracting, shareholders are not, in fact, the only residual claimants to the firm's earnings. Thus, maximizing share price is not always equivalent to maximizing total value. Blair, supra note 82. Moreover, Lynn Stout has argued elsewhere that the market price for marginal shares may not even be a good proxy for aggregate shareholder wealth if shareholders hold heterogeneous expectations of share value. Stout, supra note 147.

[179] This reality may also explain why corporate law grants shareholders unique (if highly limited) rights to inspect certain corporate books and records. See generally Clark, supra note 8, at 96-105 (describing inspection rights).

Regardless of whether shareholder voting rights are viewed as instrumental rights that serve the interests of the firm as a whole, or as compensation for shareholders' unique disabilities, the mediating hierarchy model does not appear inconsistent with shareholder voting as actually practiced in most public corporations. Practical and legal obstacles ensure that the vast majority of shareholders in the vast majority of firms exercise little or no authority over the board of directors. Thus directors can perform their mediating function free of the direct control of either the shareholders or any other group in the coalition that makes up the public corporation.

E. How Corporate Law Keeps Directors Faithful

Our discussion thus far has focused on the many features of corporate law that can be explained by the mediating hierarchy model. These features allow directors to freely balance and make tradeoffs among the competing interests of the different constituents who, we argue, comprise the firm. Yet to say that directors are *free* to maximize the joint welfare function of all the firm's members is not the same thing as saying they *will*. If directors are despots, why should they be benevolent?

Although an extended discussion of director benevolence lies beyond the scope of this Article, at least three aspects of corporate law and culture are likely to encourage directors to serve their firm's interests, however imperfectly. First, directors have an interest in serving their corporate constituents well if (as seems plausible) they enjoy and want to keep their positions. To keep their jobs, directors must meet at least the minimum demands of all of the corporations' important constituencies. Otherwise some will leave, and the coalition will fall apart. Directors may also have reputational interests in being perceived as "good" directors if they hope to be invited to serve on additional boards.

Second, corporate law encourages directors to serve their firms' interests *by severely limiting their abilities to serve their own*. Our analysis of the duty of loyalty and the business judgment rule suggests that corporate law in practice places only one significant substantive limit on director action—to wit, no self-dealing. Directors can bring home their agreed upon (and publicly reported) compensation, which may be quite substantial, but beyond this compensation they cannot use their corporate positions to expropriate assets or returns that belong to the firm. Thus corporate law seems to presume that so long as directors are limited in their ability to use their positions to benefit themselves, they may instead choose to use their positions to benefit others by promoting the joint welfare of all the stakeholders who together comprise the corporation.

As untidy as this notion may seem, a parallel argument has long been accepted as the standard explanation for nonprofit enterprise. In a seminal article on the nonprofit form, Henry Hansmann argued that the "non-distribution constraint" that restricts directors of nonprofit organizations from making direct claims on the firm's earnings serves an important economic function by inducing potential contributors to, or clients of, such firms to trust the directors to deliver services.[180] Our mediating hierarchy model suggests that Hansmann's argument can be extended to aspects of for-profit corporations as well, because directors of for-profit corporations labor also under a nondistribution constraint—the duty of loyalty—which may similarly induce coalition members to trust them as mediating hierarchs.

Finally, a third force that may work to encourage directors to serve their firms is, quite simply, corporate cultural norms of fairness and trust. Corporate law views directors as more than mere "agents." Rather, they are a unique form of fiduciary who more closely resemble trustees and whose duties are imbued with a similar moral weight. Trustees are expected to serve their beneficiaries' interests unswervingly and to settle conflicts between beneficiaries with competing interests fairly and impartially.[181] Although this idea of faithful service appears to clash with an economic analysis premised on calculations of rational self-interest, trust is one of the most fundamental concepts in law, and it lies at the heart of a wide variety of legal relationships. These relationships include not only fiduciaries such as corporate directors, legal guardians, and trustees, but the judiciary itself. After all, the need for a benevolent and trusted mediator is implicit in all of contract

[180] Henry B. Hansmann, The Role of Nonprofit Enterprise, 89 Yale L.J. 835, 838, 847 (1980).

[181] See Restatement (Third) of Trusts § 183 (1992).

theory—some sort of court system and police power are always assumed to be present in the background to enforce contracts.[182]

Economic theory has not yet developed a general theory of trust,[183] nor have economists generally focused on trust's role as an essential part of the institutional arrangements that make contracting possible. One reason economists have neglected this aspect of the problem may be the difficulty in modeling the behavior of judges (or in our model, "hierarchs") using only the traditional tools of economics. If we imagine that judges and police are rational, self-interested actors, what keeps them from being corrupted by bribes or otherwise using their positions to serve their own interests? In the case of the legal system, part of the answer appears to be that serious legal sanctions are imposed on judges and police who are caught accepting bribes. Similar considerations operate in the case of corporate directors, although the effective constraints are undoubtedly much looser. Thus the fiduciary rules of loyalty prohibit blatant self-dealing (say, by accepting a bribe).

Still, we believe that for a mediating hierarchy to work well, more may be needed. Hierarchs are only likely to be trusted if they have reputations for integrity, independence, and service, together with a desire to protect and enhance these reputations.[184]

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[182] See supra notes 79-81 and accompanying text (discussing how the mediating hierarchy model substitutes boards of directors for courts as hierarchs).

[183] For leading articles by economists on the role of trust in economic thinking, see David M. Kreps, Corporate Culture and Economic Theory, *in* Perspectives on Positive Political Economy 90 (James E. Alt & Kenneth A. Shepsle eds., 1990); Oliver E. Williamson, Calculativeness, Trust, and Economic Organization, 36 J.L. & Econ. 453 (1993). Game theorists often use the phrase "trust" to mean taking actions that put oneself at risk of being "betrayed." From the point of view of the rational actor paradigm, economists typically assume that no one would do such a thing unless they believed that it would be in the long-run best interest of the other party not to betray them and that the other party knows that it is in his own long-run best interest not to betray. Robert Gibbons uses the phrase "assurance" for actions that are taken based on such well-calculated conclusions about the other party's motives to distinguish them from actions taken in "irrational" reliance on the other party's basic character traits. See Robert Gibbons, Notes on Two Horse Races: Hobbes and Coase Meet Repeated Games (Apr. 23, 1997) (unpublished manuscript, on file with the Virginia Law Review Association); see also Bruce Chapman, Trust, Economic Rationality, and the Corporate Fiduciary Obligation, 43 U. Toronto L.J. 547 (1993) (discussing role of trust in fiduciary obligations and limits of purely instrumental rationality).

[184] See Holmstrom & Tirole, supra note 27, at 124-25. Holmstrom and Tirole discuss the desirable qualities to be found in an arbitrator:

Moreover, we believe that these reputational considerations must be reinforced by powerful social norms. This last notion is the one with which economists are most uncomfortable. Williamson argues, for example, that the only form of trust that is important in economic relationships is a carefully calculated estimate of the probability that the other party will not behave opportunistically.[185] We think there is more to it than this. Norms, such as trustworthiness, may come into existence because they have efficiency advantages, but the way they operate is to commit people ex ante to behavior that might not be welfare maximizing for those people ex post.[186] In other words, to be effective, "trust" and "integrity"

> First the arbitrator must have a good knowledge of the situation to try to duplicate the outcome of the missing optimal comprehensive contract. Second, she must be independent. With respect to the first quality, external arbitrators, like courts, are likely to incur a cost of becoming informed. This cost also exists for superiors in an organization; in particular, in large firms, the chief executives may be overloaded with decisions to arbitrate between their subordinates and have little a priori knowledge of each case; but because of everyday interaction, as well as a past familiarity with various jobs within the firm, internal arbitrators may incur a lower information cost. The second quality, independence, requires that the arbitrator not be judge and party, so as to value aggregate efficiency beyond the interest of any party. Side-contracting with the arbitrator must be prevented. Independence may fail, for instance, when the arbitrator has kept close ties with one of the involved divisions. More generally, arbitrators must have a reputation for settling disputes "fairly" (understand: "efficiently").

Id.

[185] See Williamson, supra note 183, at 463.

> [T]ransaction cost economics refers to contractual safeguards, or their absence, rather than trust, or its absence. I argue that it is redundant at best and can be misleading to use the term 'trust' to describe commercial exchange for which cost-effective safeguards have been devised in support of more efficient exchange. Calculative trust is a contradiction in terms. . . . I maintain that trust is irrelevant to commercial exchange and that reference to trust in this connection promotes confusion.

Id. at 463, 469. Williamson prefers the term "personal trust" for a noncalculative approach to human relations:

> Personal trust is therefore characterized by (1) the absence of monitoring, (2) favorable or forgiving predilections, and (3) discreteness. . . . [Hence] trust, if it obtains at all, is reserved for very special relations between family, friends, and lovers. Such trust is also the stuff of which tragedy is made. It goes to the essence of the human condition.

Id. at 483.

[186] See generally Symposium: Law, Economics, and Norms, 144 U. Pa. L. Rev. 1643 (1996) (analyzing from an economic perspective the interaction of the law and social norms); Richard H. McAdams, The Origin, Development, and Regulation of Norms, 96 Mich. L. Rev. 338 (1997) (advocating the use of norms in economic analysis of the law).

must prevent hierarchs (like directors) from behaving in opportunistic ways even when a careful calculation suggests that the benefits of betrayal outweigh the costs. Although much work remains to be done on this sort of "irrational" behavior, it suggests that a mediating hierarchy solution to problems of explicit contracting can be reinforced by the careful selection of trustworthy individuals who are supported by appropriate social norms. Thus, for example, Hansmann stresses the importance of norms in controlling the behavior of directors of nonprofit organizations, and also notes that by self-selection, directors of nonprofits will tend to be people who value their reputations and share social views about what is appropriate behavior in their role as directors.[187] We believe some of the same mechanisms may operate among directors of for-profit corporations.[188]

In sum, the mediating hierarchy model may be only a second-best solution. But given certain constraints—the necessity of maintaining the coalition in the face of market pressures, the distributional constraint imposed by the duty of loyalty, and cultural norms that support and reward trustworthy behavior—an independent board of directors that serves as a mediating hierarch may well offer substantial economic advantages over other possible forms, such as partnerships or close corporations, which allow some subset of the participants in the productive coalition to be "owners" who exercise greater control over the firm and are entitled to receive its residual profits. Recognizing this reality may resolve a number of mysteries of corporate law that have puzzled scholars who assume that the law adopts the norm of shareholder primacy.

III. CONCLUSION

In recent years it has become common for both economic and legal theorists to view a corporation as a "nexus of contracts," ex-

[187] Hansmann, supra note 180, at 875-76.

[188] Indeed, Shleifer and Summers make just this argument. See Shleifer & Summers, supra note 148, at 38-41 (arguing that shareholders who want to reassure other corporate stakeholders that they will be protected against opportunistic behavior may intentionally select irrationally trustworthy managers with personal histories of sensitivity to, and concern for, stakeholders' interests).

plicit and implicit.[189] In this Article, we propose an approach to thinking about public corporations that does not reject such contractarian thinking, but builds on it by acknowledging the limits of what can be achieved by explicit contracting. Many kinds of joint production are simply too complex and fluid to be governed by explicit contracts. Thus, an extensive literature has emerged, arguing that the gaps in explicit contracts can be filled by assigning residual control rights ("property rights") to one of the parties to the transaction. Here we explore another possibility: assigning control rights not to shareholders nor to any other stakeholder in the firm, but to a third party—the board of directors—which is largely insulated from the direct control of any of the various economic interests that constitute the corporation. Thus, we argue that an essential but generally overlooked "contract" fundamental to the nature of public corporations is the "*pactum subjectionis*" under which shareholders, managers, employees, and other groups that make firm-specific investments yield control over both those investments and the resulting output to the corporation's internal governing hierarchy.

The mediating hierarchy model we propose explains many important aspects of corporate law much more robustly than its alternatives, especially principal-agent theories premised on the notion that shareholders "own" corporations. In particular, the notion that corporate law follows a shareholder primacy norm appears to be based on two aspects of American law that seem to give shareholders unique rights to exercise control over the board of directors: derivative suits for breach of fiduciary duty and shareholder voting rights. Careful analysis reveals, however, that these rights are so limited as to be almost nonexistent. Expansive judicial interpretation of the business judgment rule generally limits shareholders'

[189] The idea that a firm is a "nexus of contracts" is usually traced to Alchian & Demsetz, supra note 33, although those authors do not use that particular phrase. See Milgrom & Roberts, supra note 21, at 20 ("[The] ability to enter contracts is critical to one of the major approaches to the economic analysis of organizations. In this view, which was first suggested by Armen Alchian and Harold Demsetz, an organization is regarded as a nexus of contracts . . . ."). Eugene Fama and Michael Jensen may have been the first to have used the phrase. See Fama & Jensen, supra note 1, at 302 ("An organization is the nexus of contracts, written and unwritten, among owners of factors of production and customers."). Since then, numerous corporate scholars have picked up on the phrase "nexus of contracts" and applied it to corporate law. See especially, Easterbrook & Fischel, Economic Structure, supra note 1, and other sources cited supra note 1.

abilities to sue successfully to rare cases of blatant self-dealing or taking of corporate opportunities. Similarly, shareholder voting rights are of such limited value in both theory and practice that they are unlikely to influence outcomes except in extreme cases. Corporate law accordingly leaves boards of directors largely free to pursue whatever projects and directions they choose, subject only to the limitation that they not use their positions for their own personal enrichment.

This result has sparked criticism from contractarian supporters of shareholder primacy who complain that corporate law fails to grant shareholders sufficient protection from the depredations of their own "agents," the board of directors.[190] Thus scholars of the law and economics school have pushed for stricter interpretations of directors' fiduciary duty, in effect revisiting the Berle-Dodd debate.[191] At the same time, progressives who reject the shareholder primacy norm in favor of a stakeholder approach also complain about existing corporate law and argue that employees as well as shareholders should be given voting rights, explicit representation on corporate boards, or standing to bring suits for breach of fiduciary duty.[192]

[190] Milton Friedman led the charge with his seminal essay. Milton Friedman, The Social Responsibility of Business Is to Increase Its Profits, N.Y. Times Mag., Sept. 13, 1970, at 33, 122 ("[A] corporate executive is an employe [sic] of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible . . . . The whole justification for permitting the corporate executive to be selected by the stockholders is that the executive is an agent serving the interests of his principal.").

[191] See, e.g., James D. Cox, Compensation, Deterrence, and The Market as Boundaries for Derivative Suit Procedures, 52 Geo. Wash. L. Rev. 745 (1984) (suggesting strengthening of duty of care); Easterbrook & Fischel, Responding to Tender Offer Offers, supra note 1 (arguing that managers should be required to adopt passive auctioneer's role in takeovers); see also Aleta G. Estreicher, Beyond Agency Costs: Managing the Corporation for the Long Term, 45 Rutgers L. Rev. 513, 593-613 (1993) (cataloging reforms that might reduce managers' discretion to pursue inefficient "short-term" agenda); cf. Charles M. Elson, Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure, 50 SMU L. Rev. 127 (1996) (suggesting directors' interests be aligned with shareholders' by paying the former in stock); Gilson & Kraakman, supra note 1 (arguing that institutional shareholders should push for more outside directors).

[192] See, e.g., Mitchell, supra note 16, at 630-43 (arguing that stakeholders should be given derivative standing to sue directors); O'Connor, supra note 16, at 962-63 (same).

A team production analysis of the public corporation suggests that both types of criticism miss the mark. If corporate law is not designed primarily to protect shareholders—if, instead, it is designed to protect *the corporate coalition* by allowing directors to allocate rents among various stakeholders, while guarding the coalition as a whole only from gross self-dealing by directors—then the rules of corporate law begin to make more sense. In particular, the mediating hierarchy approach suggests that shareholders' voting rights *should* be extremely limited, and that shareholders should be allowed to sue directors *only* when this serves the interest of the corporation as a whole, rather than serving shareholders' interests at the expense of other stakeholders. The mediating hierarchy model thus explains important aspects of modern corporate law that have puzzled and provoked both the law and economics school and their progressive opponents.

The mediating hierarchy approach offers other valuable lessons as well. First, it highlights the importance of team production dynamics in the rise of the public corporation as a vehicle for doing business. When the central contracting problem investors face is the principal-agent problem, they do not need public corporations. Instead, they can organize and manage their businesses using explicit contracts and alternative organizational forms—including partnerships, limited liability companies, and privately-held corporations—that permit them to retain far more control over managers and employees.[193] The fact that the lion's share of our nation's largest firms have opted to do business as public corporations rather than private companies or partnerships thus suggests there may be significant economic advantages to the public corporation form in spite of (or, as we suggest, because of) the requirement of ceding control to an independent board of directors. Of course, this argument assumes that the public corporation has thrived because corporation law offers unique advantages in organizing economic production. One could tell a different kind of story in which the public corporation has achieved dominance because political or historical factors (say, tax rules or the early development of a liquid

[193] Some scholars have argued that a particular form of the private corporation, a "leveraged buyout" firm, is a superior organizational form for exactly this reason. See generally Michael C. Jensen, Eclipse of the Public Corporation, Harv. Bus. Rev., Sept.-Oct. 1989, at 61.

stock market) have made the corporate form attractive for business *despite* legal rules that are less than optimal.[194] But if the rise of the public corporation can be traced in whole or in part to efficiency advantages of corporate law, the prevalence of public corporations suggests that team production problems are far more pervasive—and the contracting problems associated with them far more endemic and costly—than is generally recognized. Hence we hope that both economists and legal scholars will give more attention in the future to these contracting problems.

A second lesson to draw from team production theory concerns the fundamentally political nature of the corporation.[195] Scholarly and popular debates about corporate governance need to recognize that corporations mediate among the competing interests of various groups and individuals that risk firm-specific investments in a joint enterprise. These groups will inevitably use political tools, in addition to economic and legal tools, to try to capture a larger share of the rents produced by team production. Thus, future scholarship should explore in greater detail the internal and external political and economic pressures that affect the decisionmaking process in firms.[196] Just as a burgeoning "public choice" literature now studies the politics of decisionmaking within legislatures and government agencies,[197] corporate scholars need to develop a lit-

[194] See, e.g., Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 Va. L. Rev. 757 (1995) (exploring path-dependent theory of corporate law in which inefficient legal rules persist due to network externalities).

[195] See Henry Hansmann, The Ownership of Enterprise 287 (1996) ("One theme that has emerged with particular force is the importance of viewing the firm as a political institution.").

[196] Jack Coffee, Lynne Dallas, and Mark Roe are among the scholars who have made important strides in this direction. See, e.g., Coffee, supra note 16 (describing a corporation as a series of unstable political coalitions involving shareholders, managers, and other stakeholders); Lynne L. Dallas, Two Models of Corporate Governance: Beyond Berle and Means, 22 U. Mich. J.L. Reform 19 (1988) (exploring "power model" of the firm as a coalition comprised of many constituencies that compete politically for power and control); Mark J. Roe, A Political Theory of American Corporate Finance, 91 Colum. L. Rev. 10 (1991) (exploring political reasons why financial institutions have not, historically, been powerful forces in corporate boardrooms in the United States); Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (1994) (same).

[197] See generally Dennis C. Mueller, Public Choice II (1989) (defining public choice as the application of economic principles to the political process and summarizing current public choice theory).

erature that approaches the study of corporate governance with attention to the use of political tools (including vote trading, coalition formation, public relations campaigns, organizing to reduce obstacles to collective action, and appeals to regulatory agencies and congressional investigative committees), and to the role of cultural norms in reducing and resolving conflict. They also need a richer literature on the ways in which economic pressures can shift the balance of power within corporations.

This brings us to our final lesson. It is widely perceived that during the late 1960s and 1970s, the performance of U.S. firms deteriorated markedly, and some have argued that boards of directors of American companies may have been both overly generous to employees and top management and insensitive to the wishes of the shareholders.[198] Corporate America became fat and lazy, and returns from share ownership declined. Eventually (according to the conventional wisdom), these "inefficiencies" became so great that they sparked the 1980s takeover movement and a decade and a half of corporate restructurings and downsizings.[199] This restructur-

[198] The multifactor productivity growth rate in the business sector fell from more than 2% per year from 1948 to 1968, to around 1% per year from 1968 to 1973, then collapsed to less than 0.25% from 1973 to 1979. See Martin Neil Baily et al., Growth With Equity: Economic Policymaking for the Next Century 16 (1993). Although the rate of growth in hourly compensation for employees fell off sharply in the 1970s, see id. at 21, labor's share of national income rose from 68.5% in 1959 to 73.2% in 1979. See Lawrence Mishel, Capital's Gain, Am. Prospect, July-Aug. 1997, at 71. From 1965 through 1982 the Dow Jones Industrial Average declined by 2.9%, from 910.88 at the end of 1965, to 884.36 at the end of 1982. See 1998 Econ. Rep. President 390 tbl.B-95; see also infra note 199.

[199] During the late 1960s and early 1970s, for reasons that economists are still trying to understand, the aggregate return on capital plummeted. By the end of the 1970s and early 1980s, the return on capital in the United States was at post-World War II lows, as reflected in the dismal performance of the stock market in the 1970s. (This decline in the return on capital appears to have been economy-wide, affecting both the corporate and the noncorporate sectors, though the decline hit the manufacturing sector—which is dominated by publicly-traded corporations—especially hard.) Then, in the early 1980s, the cost of capital (a key component of which is the "real," or inflation-adjusted, interest rate) was driven to unprecedented highs by a combination of soaring federal budget deficits and efforts by the Federal Reserve to get inflation under control. The result was that, throughout most of the decade of the 1980s, the real cost of capital exceeded the real return on capital across broad sectors of the U.S. economy. See generally Margaret M. Blair & Robert E. Litan, Corporate Leverage and Leveraged Buyouts in the Eighties, *in* Debt, Taxes, and Corporate Restructuring (John B. Shoven & Joel Waldfogel eds., 1990); Margaret M. Blair & Martha A. Schary, Industry-Level Indicators of Free Cash Flow, *in* The Deal Decade: What

ing process has produced "leaner and meaner" corporations that are more attentive than ever to shareholders' desires, and returns from share ownership have correspondingly increased.[200] At the same time, directors' new focus on shareholders' interests has adversely affected other corporate constituencies—especially rank-and-file employees—whose relative returns from participating in the corporate enterprise seem to have shrunk even as shareholders have prospered.[201]

How should corporate scholars interpret, and lawmakers respond to, these events? The mediating hierarchy approach suggests two intriguing possibilities. First, corporate directors as mediating hierarchs enjoy considerable discretion in deciding which members of the corporate coalition receive what portion of the economic surplus resulting from team production. Although the board must meet the minimum demands of each team member to keep the coalition together, beyond that threshold any number of possible allocations among groups is possible. Thus, the returns to any particular corporate stakeholder from participating in the corporation will be determined not only by market forces, but by *political* forces.[202] This analysis in turn suggests that the rise in the 1980s of institutional shareholders such as investment companies and pension funds (which control sizeable blocks of shares in many firms)

Takeovers and Leveraged Buyouts Mean for Corporate Governance 99 (Margaret Blair ed., 1993); Margaret M. Blair & Martha A. Schary, Industry-Level Pressures to Restructure, *in* The Deal Decade, supra, at 149; Margaret Mendenhall Blair, A Surprising Culprit Behind the Rush to Leverage, Brookings Rev., Winter 1989/90, at 19 (all offering detailed empirical accounts of the widespread collapse of the return on capital and rise in the real cost of capital in the 1980s, and examining evidence of the links between these developments and corporate restructuring in the 1980s).

[200] See, e.g., Bernard S. Black & Joseph A. Grundfest, Shareholder Gains from Takeovers and Restructurings Between 1981 and 1986: $162 Billion Is a Lot of Money, 1 J. Applied Corp. Fin. 5, 6 (1988) ("Shareholder gains from takeovers . . . reflect the market's expectation that these transactions will increase the value to investors of the operations being sold. The gains reflect in substantial part investor expectations that the new owners will run the acquired businesses more efficiently."). Since 1982, the Dow Jones Industrial Average has increased from 884.36 to 7909 at the end of 1997, a nearly eight-fold increase in 15 years. See 1998 Econ. Rep. President 390 tbl.B-95.

[201] See generally Mishel, supra note 198; see also Stephen Roach, Angst in the Global Village, Challenge, Sept.-Oct. 1997, at 95 (arguing that economic power has shifted strongly from labor to capital in the last 15 years).

[202] See supra text accompanying note 76 (arguing that under a mediating hierarchy system, team members' rewards from team production will be in part determined by political power).

has tipped the political balance of power toward shareholders by reducing obstacles to collective investor action. It further suggests that the decline of labor unions during the same period[203] has made it more difficult for labor to protect its stake in the corporate enterprise. The net result is that shareholders as a class have acquired additional political power that allows them to capture a larger share of the rents from the corporate enterprise, and have thus grown richer, while employees as a class have lost political power, and have thus grown relatively poorer.[204]

Yet the mediating hierarchy model also suggests a second possible interpretation of this redirection of corporate wealth from employees to shareholders. In particular, the shift can be explained as a response to changing market forces which have altered various team members' opportunity costs and thus, the minimum rewards they must receive to have an incentive to remain in the team. Technological change and an increasingly globalized economy have exerted downward pressure on U.S. workers' wages while increasing investors' opportunities to seek higher returns abroad.[205] Recognizing this reality, corporate boards have also recognized that they must redirect some of the surplus produced by corporate team production from employees to shareholders in order to prevent the flight of capital and keep the coalition together. In other words, corporate boards' recent focus on shareholder wealth may

[203] See generally Unions in Transition: Entering the Second Century (Seymour Martin Lipset ed., 1986) (examining the challenges facing unions during a period of apparent political and economic decline).

[204] The return on capital in the United States is now back up to post-war highs, and there are signs that corporations may now be under pressure to shift power and rents to employees to attract and keep the human capital they need in the coalition. See, e.g., Joann S. Lublin & Joseph B. White, Dilbert's Revenge: Throwing Off Angst, Workers Are Feeling In Control of Careers, Wall St. J., Sept. 11, 1997, at A1; Bernard Wysocki Jr., Retaining Employees Turns into a Hot Topic, Wall St. J., Sept. 8, 1997, at A1. Wall Street economist Stephen Roach takes a pessimistic view of the changing economic pressures, predicting "worker backlash" if power and rents are not shifted. "[E]conomic power is about to shift from capital back to labor," he writes. "With business profits surging and the rate of return on corporate capital at a twenty-eight-year high, close to fifteen years of stagnant real wages suggest[] that labor [is] about to clamor for a larger slice of the pie." See Roach, supra note 201, at 101.

[205] See generally Gary Burtless et al., Globaphobia: Confronting Fears about Open Trade (1998) (discussing the economic impact of increasing world trade, and analyzing the extent to which globalization or technological change is responsible for increasing wage inequality in the United States).

be an appropriate and economically efficient response to changes in the underlying markets for capital and labor.

In either case, we do not think it is an accident that the idea of shareholder primacy has become increasingly popular among academics during this period. Our theory suggests that the shift in the balance of power in boardrooms toward shareholders is the result not of directors' sudden recognition that shareholders are in fact "owners" of the corporation, however, but of changing economic and political forces that have improved shareholders' relative bargaining power vis-a-vis other coalition members. If the driving forces are political, whether shareholders or employees receive a greater share of the rewards of the corporate enterprise may be a matter that raises primarily distributional concerns. If the shift reflects economic factors, however, it represents an efficient readjustment essential to continued team production. Thus, at a normative level our story cautions against attempts to "reform" corporate law either by contractarians who want to enhance shareholders' power over directors, or progressives who want to give other stakeholders greater control rights.[206] Strikingly, corporate law itself has proven remarkably immune to both sorts of proposals, and continues to preserve directors' discretion to act as mediators among all relevant corporate constituents.

Thus we are not, so far, concerned about the direction that the law has taken. Nonetheless, we are somewhat concerned about the shift in rhetoric and in corporate culture that has taken place in recent years.[207] We would not want the legal community, and especially

[206] The mediating hierarchy model suggests that reform proposals designed to give stakeholders greater power over directors are misguided if they are driven by efficiency concerns about the supposed inability of current law to protect nonshareholders' firm-specific investments. See, e.g., Mitchell, supra note 16, at 607-09 (raising efficiency concerns); O'Connor, supra note 16, at 917-40 (same). We do not address here whether such reforms might be desirable on distributional or equitable grounds.

[207] See John A. Byrne, The Best & Worst Boards: Our New Report Card on Corporate Governance, Bus. Wk., Nov. 25, 1996, at 82, 94 (quoting Chrysler director John B. Neff that "'[t]he message of enhancing shareholder value is now part of most boardroom conversations these days. . . . Chief executives know that if they don't do the job, they may well find shareholders knocking at their door.'"). The shift in norms has been reinforced by changes in compensation patterns for corporate officers and directors, which have moved toward systems strongly tied to stock price performance. Academics, management consultants, and other commentators have promoted and

the judiciary, to take the shareholder primacy rhetoric too seriously, lose sight of the important economic function played by boards that are free to mediate among competing interests, and begin to alter the law in ways that would compromise the independence of directors.[208] For this reason, we believe that the emphasis placed on principal-agent problems in the corporate literature during the last two decades has been both excessive and misleading. We are convinced that future debates about corporate governance will be more fruitful if they start from a better model that more accurately captures the fundamental contracting problem corporation law attempts to resolve. The mediating hierarchy model is a first step toward that better view.

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praised these changes. See, e.g., Ira T. Kay, CEO Pay and Shareholder Value: Helping the U.S. Win the Global Economic War (1998).

[208] Our emphasis on the importance of protecting directors from too much legal control by any corporate stakeholders should in no way be interpreted as a defense of lazy, incompetent, or self-serving directors. We believe, however, such directors will in most instances be forced ultimately to respond to economic pressures (such as falling stock prices or difficulties in hiring adequate talent) and to political pressures (such as negative publicity campaigns). We would rather see aggrieved stakeholders use such tools than to change the law in ways that seriously weaken the formal protections now provided for directors by the law.