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CORPORATE ACCOUNTABILITY

DIRECTOR ACCOUNTABILITY AND THE MEDIATING ROLE OF THE CORPORATE BOARD

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Abstract

One of the most pressing questions facing both corporate scholars and businesspeople today is how corporate directors can be made accountable. Before addressing this issue, however, it seems important to consider two antecedent questions: To whom should directors be accountable? And for what?

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Contemporary corporate scholarship often starts from a “shareholder primacy” perspective that holds that directors of public corporations ought to be accountable only to the shareholders, and ought to be accountable only for maximizing the value of the shareholders’ shares. This perspective rests on the conventional contractarian assumption that the shareholders are the sole residual claimants and risk bearers in a public firm. More recent work in economics suggests, however, that this assumption is false. In particular, options theory and the growing literature on the contracting difficulties associated with firm-specific investment both support the claim that a wide variety of groups are likely to bear significant residual risk and enjoy significant residual claims on firm earnings. These groups include not only shareholders, but also creditors, managers, and employees. Thus economic efficiency may be best served not by requiring corporate directors to focus solely on shareholders’ interests, but by requiring them instead to maximize the sum of all the interests held by all the groups that bear residual risks and hold residual claims.

In accord with this view, we argue that corporate directors ought to be viewed not as “agents” who serve only the shareholders, but as “mediating hierarchs” who enjoy ultimate control over the firm’s assets and outputs and who are charged with the task of balancing the sometimes-conflicting claims and interests of the many different groups that bear residual risk and have residual claims on the firm. This mediating model of the board’s role offers to explain a variety of important doctrines in U.S. law that preserve director autonomy and insulate the board from the command and control of the shareholders or indeed any other group. At the same time, the mediating model raises the question of why directors who are largely insulated from outside pressures should be expected to do a good job of running the firm. We suggest that answers to this question are available, but only if we are willing to look beyond the homo economicus model of rationally selfish behavior commonly employed in economic analysis and to consider as well the extensive empirical evidence in the social sciences literature on the phenomenon of intrinsically trustworthy, other-regarding behavior. We briefly explore how this literature both supports the claim that directors may behave trustworthily even when

they do not have explicit incentives to do so, and suggests some of the circumstances that are likely to promote accountable director behavior.

I. INTRODUCTION

Public corporations control trillions of dollars of assets, employ millions of people, and produce many of the goods and services we consume in our daily lives. Public corporations, in turn, are controlled by boards of directors.¹ The issue of director accountability, as a result, is one of tremendous importance. But before attempting to address the question of how directors can be held accountable, it seems sensible to consider two antecedent questions: to whom should directors be accountable; and, for what?

For nearly as long as the public corporation has existed, scholars, practitioners, and policymakers have debated the job description and legal obligations of corporate directors.² But to anyone who entered the debate in the last decade and read only the dominant academic commentary or informal discussions in the business press, the issue might appear conclusively settled in favor of the following two propositions: first, the board's only job is to faithfully serve the interests of the firm's shareholders; and second, the best way to do this is to maximize the value of the company's shares.³

The idea that shareholders alone are the *raison d'être* of the corporation dominates contemporary discussion of corporate governance, both outside and, in many cases, inside the boardroom. Yet the "shareholder primacy"

1. Since the early twentieth century, both the common law and state codes have required that boards of directors manage publicly held corporations. See Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 348-49 & n.7 (1991). In contrast, many states allow close corporations to be run directly by their shareholders. See *infra* note 86.

2. A classic example can be found in the early debate between Professors Adolf Berle and Merrick Dodd. See Adolf A. Berle, *Corporate Powers As Powers in Trust*, 44 HARV. L. REV. 1049 (1931); E. Merrick Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

3. See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 253 & nn.15-16 (1999) (reviewing extensive literature asserting or assuming that directors should serve shareholders exclusively). This view is so dominant in recent scholarship that two prominent legal scholars recently proclaimed that the entire world is converging on the belief that the best means to maximize social welfare is "to make corporate managers strongly accountable to shareholder interests and, at least in direct terms, only to those interests." Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441 (2001). The authors appear to be using the term "managers" in its broadest sense, meaning managers and directors.

claim seems at odds with a variety of important characteristics of U.S. corporate law. Despite the emphasis legal theorists have given shareholder primacy in recent years, corporate law itself does not obligate directors to do what the shareholders tell them to do. Nor does corporate law compel the board to maximize share value.⁴ To the contrary, directors of public corporations enjoy a remarkable degree of freedom from shareholder command and control. Similarly, the law grants directors wide discretion to consider the interests of other corporate participants in their decision making—even when this adversely affects the value of the stockholders' shares.⁵ If directors are really supposed to run firms solely for the benefit of shareholders, how can we explain this pattern? Why does corporate law shield directors from shareholder control and protect them from shareholder lawsuits when they pursue corporate strategies that benefit other groups, including employees, managers, and creditors, at the shareholders' expense?

The answer, we argue here, may lie in recognizing that shareholder primacy is both positively and normatively incorrect, at least in the extreme rhetorical form in which it is most commonly expressed. Corporate law does not—nor should it—require directors to maximize the value of the company's common stock. To the contrary, it grants—and should grant—the directors of public companies enormous freedom to decide where and how the firm ought to allocate its scarce resources. This arrangement does not preclude corporate directors from using their autonomy to pursue a higher stock price. However, it also does not prevent directors from using the firm's resources instead to benefit managers, employees, or even the local community.

To explain why it may be desirable that directors enjoy this degree of discretion, we begin by reexamining the theoretical foundations of the shareholder primacy claim. The notion that directors ought to focus solely on

4. As a result, some scholars have proposed changing the law to require directors to follow shareholder primacy. *See, e.g.*, Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277 (1990) (arguing that directors' fiduciary duties should be interpreted to require them explicitly to maximize share value, rather than the less precise requirement in current law that directors' actions should serve the interests of the corporation and its shareholders). *See also* MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 116-21 app. 3-1 (1995) (listing changes in law and corporate governance proposed in the late 1980s and early 1990s for the purpose of enhancing shareholder power and influence).

5. In recent years, a majority of the states have adopted "other constituency statutes" that expressly authorize corporate boards to consider the interests of nonshareholder groups in making their decisions. *See generally* Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1992). Although no constituency statute exists in Delaware, Delaware case law generally grants directors discretion to consider nonshareholder interests. *See infra* text accompanying notes 64-74.

maximizing the market value of the shareholders' interest in the firm rests on a prominent idea in economic theory that we refer to as the "principal-agent model" of the firm.⁶ According to the principal-agent model, the shareholders in a public corporation are the true owners of the firm or, in more sophisticated accounts, its residual claimants. Directors are mere agents whom the shareholders hire to run the firm because they lack the skill, time, or inclination to run it themselves. The obvious corollary is that, provided the firm does not violate the law, directors ought to serve and be accountable only to the shareholders.

Ironically, even as the rhetoric of shareholder primacy becomes increasingly influential in academic and corporate circles, contemporary work in theoretical and empirical economics has begun to suggest that we should question the validity of the principal-agent model as a description of the shareholder-director relationship. A full review of the relevant legal and economic literature lies well beyond the scope of our inquiry. Rather, we offer an introduction to some of the recent work in this area and explore the resulting implications for the shareholder primacy claim. In this process, we weave together a number of ideas discussed in greater detail in our prior articles, and also explore new ideas as well.⁷

We begin by considering why a rule of strict shareholder primacy might at times be inefficient. In particular, we examine how options theory, contemporary work on implicit contracting, and contemporary work on firm-specific investment all suggest that a strict rule of shareholder primacy would, in some fairly common situations, require directors to pursue strategies that actually reduce the economic value of the firm.

6. One might go further and presume that maximizing the economic value of the shareholder's interest means maximizing today's share price. This extreme form of shareholder primacy relies on a second economic idea known as the "efficient capital markets hypothesis" (ECMH). As commonly understood, the ECMH predicts that the market price of a publicly traded security should incorporate all available public information relevant to estimating that security's future risks and returns. *See, e.g.,* Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575, 1575 (1991) (defining the "market efficiency hypothesis" as "the simple statement that security prices fully reflect all available information"). Sometimes this is interpreted to mean that the market should be "fundamental value efficient," meaning that absent contradictory private information, today's stock price represents the best possible estimate of the long-term, as well as the short-term, value of the shareholders' stock. This assumption about market prices refines the prescription that directors should serve only shareholders to a more precise prescription that, to serve shareholders, directors should always try to maximize today's share value. *See* Lynn A. Stout, *Stock Prices and Social Wealth* 3-4, 26-36 (Harvard John M. Olin Discussion Paper Series No. 301 (2000) (discussing and critiquing this notion), available at http://www.law.harvard.edu/program/olin_center).

7. *See, e.g.,* BLAIR, *supra* note 4; Blair & Stout, *supra* note 3; Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. (forthcoming 2001); Stout, *supra* note 6.

We then present an alternative model of directors' duties that builds on this insight. This alternative model relies on the idea that the primary economic function of directors in public corporations may not be to act as shareholders' agents but, instead, to serve as "mediating hierarchs" charged with balancing the sometimes competing interests of a variety of groups that participate in public corporations. We argue that the mediating board can serve efficiency by providing a second best solution to the complex team production contracting problem that often arises among creditors, employees, managers, majority and minority shareholders, and other groups that bear risks or make firm-specific investments in public companies. We also argue that the mediating hierarchy model provides a better explanation for many important features of contemporary corporate law than the principal-agent model does.

To the extent it reflects the reality of the modern public corporation, the mediating hierarchy model carries important implications for our understanding of: (1) what the law requires of directors, (2) whose interests boards should serve, and (3) how boards actually work. In particular, the mediating hierarchy model emphasizes the importance of ensuring that directors enjoy a wide range of discretion in determining whether corporate resources should be used to benefit shareholders or to benefit some other set of participants (such as creditors, employees, or upper-level managers) who bear risk or make firm-specific investments in the enterprise. A necessary corollary is that none of these groups—including shareholders—should be able to exercise direct control over the board.

We conclude by addressing the obvious problem raised by such an approach: namely, why should a mediating board that is largely insulated from the shareholders' control (indeed from anyone's control) do a good job? We suggest that answers to this question are readily available—if we are willing to look beyond the economic literature and consider the extensive work that has been done in other branches of the social sciences on the phenomenon of intrinsic trustworthiness. This work suggests that in a variety of circumstances, directors can be counted upon to behave trustworthily in mediating among the interests of the many different groups that bear risks and make firm-specific investments in public firms, even when they will suffer no obvious punishment if they fail to do so. Director trustworthiness largely depends, however, on a variety of social signals and variables—signals and variables that commentators who adopt the principal-agent model tend to overlook. If we want to promote director accountability, it is essential that these social factors support, rather than undermine, directors' roles as trusted mediators.

II. THE PRINCIPAL-AGENT MODEL AND THE ECONOMIC ARGUMENT FOR SHAREHOLDER PRIMACY

In the business press, the argument for shareholder primacy often begins with the simple assertion that shareholders are the true owners of the corporation.⁸ For example, in his famous 1970 *New York Times* essay declaring that “the social responsibility of business is to increase its profits,” Milton Friedman referred to shareholders as “owners” and wrote of corporate assets as if they belonged to shareholders.⁹ Commentators who use the rhetoric of property rights to justify shareholder primacy bring a strong moral overtone to their arguments, implying that any use of corporate assets that does not directly enhance shareholder wealth is a form of theft. Yet from a logical perspective, the naked claim that shareholders own the corporation is just that—a naked claim. As a legal matter, shareholders neither control how the firm’s assets are used, nor are entitled to receive dividends or to make any other direct claim on the firm’s earnings.¹⁰

8. The idea that business corporations should exist solely to make profits for shareholders may have historically originated in the *ultra vires* argument that corporations, which originally were chartered for specific purposes deemed to be in the public interest, did not have legal authority to engage in activities not specified in their corporate charters. See LEWIS D. SOLOMON ET AL., *CORPORATIONS: LAW AND POLICY* 91-92 (4th ed. 1998). Even after general purpose corporate charters became widely available, corporations could not change their charter or the fundamental nature of their business without the unanimous approval of their “members” or shareholders. *Id.* at 371-72. These antecedents may help explain the modern tendency to describe shareholders as “owners”. Contemporary corporate law, however, treats corporations as separate and autonomous legal persons whose boards of directors have authority to make decisions and take action without shareholder approval.

9. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32-33, 122-26 (“[A] corporate executive is an employee of the *owners of the business*.”) (emphasis added). Friedman’s argument addressed whether corporations should be “socially responsible” or simply pursue profits. *Id.* Friedman believed it was dangerous to permit corporate managers and directors, who are not elected by and accountable to ordinary voters and members of society, to make unchallengeable decisions about what they believed to be “socially responsible” and to direct the sometimes vast resources under their control toward those ends. *Id.* This potential problem is closely related to the one we address in our argument here, and in Parts IV and V we take it up more directly when we discuss constraints on directors’ behavior. See *infra* text accompanying notes 92-94, 101-08.

10. Shareholders neither own nor have the right to control corporate assets. *Bryan v. Aiken*, 86 A. 674, 684 (Del. Ch. 1913) (“The [stockholder] does not, and cannot own the property of the corporation, or even the earnings, until they are declared in the form of dividends.”). Moreover, the legal rights shareholders do enjoy (for example, the right to elect directors, to veto certain corporate transactions by majority voting, to offer proposals that the directors are often free to ignore, to receive dividends if and when the directors declare them) look very different from the rights enjoyed by those who own physical assets such as land or jewelry. The assertion that shareholders are “owners” of corporations functions, as a result, is primarily a rhetorical device designed to trump all other arguments. It is not, by itself, a serious legal or economic argument.

Ironically, Friedman’s essay appeared just as other contemporary scholars were explaining why shareholders in publicly traded firms could not be said to “own” corporate assets in any traditional

The more serious argument for shareholder primacy can be found in the work of so-called “contractarian” corporate scholars, as summarized and explored in Easterbrook and Fischel’s influential book *The Economic Structure of Corporate Law*.¹¹ Contractarian scholars argue that a corporation is best understood as a “nexus of contracts” entered into by numerous corporate participants who hope to profit from contributing resources to and working together in a productive enterprise. These participants enter into explicit and implicit contracts with the firm that define what they are supposed to contribute and what they are supposed to receive in return. According to most contractarians, nonshareholder participants in the firm (including bondholders, managers, and employees) demand contracts that require them to be fully compensated out of any revenues earned by the enterprise before any payments can be made to shareholders. Shareholders are thus said to be the firm’s “residual claimants.”

As residual claimants, shareholder’s fortunes are clearly tied to the firm. If profits increase, the shareholders benefit from this bounty; if profits decline, shareholders feel the loss. Shareholders therefore supposedly have the most need for, and are willing to pay the highest price for, control over the corporation. (Everyone else’s returns supposedly are protected—and limited—by the terms of their contracts.) According to this theory, shareholders get to elect corporate directors because they implicitly bargained for this right, accepting a higher degree of risk than other groups in exchange for it. Shareholders, accordingly, should be viewed as the principals in the firm, and the directors who actually control the enterprise should be viewed as mere agents whom the shareholders employ to serve their interests. Consequently, directors should faithfully attend to the interests of the shareholders—and not to the interests of any other group—in carrying out their duties. Put in legal terms, directors owe their fiduciary duties to the shareholders alone.

III. ECONOMIC ARGUMENTS AGAINST SHAREHOLDER PRIMACY

Taken at face value, the principal-agent model of the firm implies that shareholder primacy is desirable. But does the principal-agent model really

sense of that word. *See, e.g.*, DOW VOTAW, MODERN CORPORATIONS 96-97 (1965) (noting that “the corporate concept divides this bundle of rights [associated with “property”] into several pieces” and allocates them to different participants).

11. FRANK EASTERBROOK & DANIEL FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991). A vast literature, both preceding and succeeding this work, further develops and analyzes the basic argument and related ones as well. *See* Blair & Stout, *supra* note 3, at 258-65 (citing some of the literature).

describe the public corporation? We believe not. In recent years, a number of scholars have explored economic arguments that suggest the principal-agent model may be seriously flawed and that a strict rule of shareholder primacy could be inefficient.¹² We review some of those arguments briefly below.

A. *How Options Theory Undermines the Principal-Agent Model*

Options theory is a relatively recent development in finance theory that fatally undermines the idea that shareholders, or any other group, are the sole residual claimants of a public corporation.¹³ This is because options theory demonstrates that the value of all financial securities can be decomposed into two parts: (1) the value due to the expected stream of income the security provides, and (2) the value of the “options” or “futures” features in the security.¹⁴ For example, basic corporate debt and equity securities can be

12. See BLAIR, *supra* note 4, at 202-34 (arguing that shareholders are not the “owners” of corporations in any traditional legal or economic sense of the word and not the only residual claimants); Blair & Stout, *supra* note 3, at 265-76 (arguing against shareholder primacy using team production analysis). See also Stout, *supra* note 6, at 5-15 (arguing that the fundamental value version of the ECMH relies on the unrealistic assumption that investors share identical expectations about the future and that recent empirical work undermines even the informational efficiency version of the theory by suggesting that stock prices respond to some forms of public information quite slowly). For this reason and others, stock prices cannot be relied upon as a measure of the value created by corporations. *Id.*

13. Technically, traditional finance theory says a security’s value is determined by both the stream of income, and the “beta” or nondiversifiable risk associated with that stream of income. See generally RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 49-67 (4th ed. 1991). Modern options theory adds that conditional claims associated with the security also affect its value. The first essays modeling precisely how financial options should be valued were published in the 1970s. See Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973) (developing a mathematical model for pricing financial options); Robert Merton, *Theory of Rational Option Pricing*, 4 BELL J. ECON. 141 (1973) (same). Merton and Scholes received the Nobel Prize in Economics for their work on options theory in 1997.

14. Options come in two basic varieties. A “call option” gives the buyer the legal right to purchase the underlying asset during some fixed interval, or at some fixed time, for a fixed price. The option seller conveys this right in exchange for an upfront payment. A “put option” gives the option buyer the right to sell the underlying asset at a fixed price during some fixed interval, or at some fixed time, again in return for an upfront payment. Related to options are futures contracts, which, rather than giving one of the parties a right to buy or sell at a set price some time in the future, requires the seller to transfer the asset to the buyer on some future date at a price specified in the present contract. Options and futures contracts are both derivative securities (that is, their value is derived from some underlying asset). Options are more important to corporate law than are futures, so we confine our present discussion to options. See Frank Partnoy, *Adding Derivatives to the Corporate Law Mix*, 34 GA. L. REV. 599, 604 (2000) (“Options are more important than forwards in corporate law.”). Partnoy’s essay provides an excellent introduction to the implications of options theory for corporate law. Other outstanding works on related subjects include: G. Mitu Gulati et al., *Connected Contracts*, 47 UCLA L. REV. 887 (2000); Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273 (1991); and Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214 (1999).

reconceptualized as contracts between buyers and sellers of options.¹⁵

Imagine an entrepreneur who holds one hundred percent of the equity shares of a corporation and decides that the firm should borrow money by issuing a twenty million dollar bond to an institutional investor. The bond is due in two years with no interest payments required in the interim (it is a “zero-coupon” bond), and the firm is otherwise debt-free. The economic relationship between the entrepreneur and the institutional investor can be described in the following terms: the entrepreneur “owns” the right to the net cash flow generated by the original unleveraged firm. In issuing the bond, however, the entrepreneur bought a put option (a right to sell his interest in the firm) from the institution. If the present value of the firm’s cash flow drops to less than twenty million dollars by the date the bond is due, which is equivalent to the option “exercise date”, then the entrepreneur can require the institution to “buy” his claims to the cash flow of the firm for twenty million dollars by simply defaulting on the loan and letting the institution take possession. The entrepreneur can then walk away without further obligation.

Alternatively, the relationship could be described as one in which the institution “owns” the right to the cash flow from the unleveraged version of the firm, but sold a call option to the entrepreneur. In other words, the entrepreneur has the right to buy the claim to all the firm’s cash flow from the institution on the exercise date for twenty million dollars. If the present value of the firm’s cash flow exceeds twenty million dollars on the date the bond is due, the entrepreneur can be expected to “exercise” his call option by paying off the loan. If, however, the present value of the cash flow is less than twenty million dollars, the entrepreneur can choose not to exercise the option and cede his interest in the firm to the institution.

From the standpoint of the financial claims and risk being borne by the two parties, these two ways of understanding their relationship are exactly equivalent. This equivalency, in turn, reveals the difficulty in economic theory of trying to establish a claim of special status for shareholders as a result of any supposed property or ownership interest. It is equally sensible to describe either the stockholder or the institutional bondholder as the firm’s true “owner”, with the other party holding some sort of contingent claim. Options theory destroys any notion that shareholders can be uniquely

15. We use the word “option” in its economic rather than its legal sense. In other words, we do not intend to suggest that corporate stocks and bonds are the same types of securities as the short-term options contracts commonly traded on securities and commodities exchanges. The latter are contracts between third parties (essentially zero-sum bets on the future price of an underlying corporate stock) and not claims against the corporation itself.

described, in economic terms at least, as “owners” of corporations.¹⁶

Options theory also makes clear that shareholders are rarely the only corporate participants who have a stake in how the firm is managed. An increase in risk increases the value of an option to its holder, at the expense of the option holder’s counterparty, the option “writer”.¹⁷ In the context of a corporation, this means that committing the firm to a riskier strategy will increase the value of the shareholders’ interest in the firm while reducing the value of the debtholders’ interest. Shareholders, like call option holders, capture the upside potential of risky projects, while debtholders, who are in a position similar to sellers of put options, may bear all or most of the downside risk.¹⁸ This last point is important, for it implies that requiring directors to maximize share value will not necessarily maximize the total value of the corporation. In fact, the firm’s economic value can be reduced by encouraging directors to accept inefficient risks that increase the value of the shareholders’ interest while simultaneously decreasing the value of the debtholders’ interest by an even greater amount.¹⁹

Consider the example of a firm that has fifteen million dollars in debt and twenty million dollars in assets. The directors of the firm then evaluate a

16. Both statutory and case law generally fail to distinguish between debt and equity on the basis of clear and identifiable characteristics that separate the two, except for purposes of determining whether the payments to the security holders are considered deductible business expenses for tax purposes. See William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971). A few state statutes simply define “shares” as “the units into which the proprietary interests in a corporation are divided.” See, e.g., CAL. CORP. CODE § 184 (West 2001). And a few court opinions simply assert that equity holders have a different kind of interest in the firm, one that is a “property interest” or “proprietary interest.” See, e.g., *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988) (reasoning that holders of convertible securities are not owed fiduciary duties because they have a “mere expectancy interest” and not “an existing property right or equitable interest”). These opinions, however, fail to explain what, other than their label, distinguishes a “property interest” from other kinds of financial interests in corporations.

17. See RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 245 (1993) (applying options perspective to explain basic conflicts of interest between debtholders and equity holders); STEPHEN A. ROSS ET AL., CORPORATE FINANCE 582-86 (4th ed. 1996) (noting that the value of options depends on variability of underlying security).

18. The notion that share value can be enhanced by increasing risk has been long understood implicitly by legal theorists, and this idea influences the structure of bankruptcy law. The development of formal options theory, however, confirmed this view, and helped to enhance its profile among corporate law scholars in recent years. See Partnoy, *supra* note 14, at 603; see also Hu, *supra* note 4, at 295-300 (noting that corporate health and shareholder welfare are not the same, that classic fiduciary principles tend to encourage managers to focus on reducing the total risk affecting the firm rather than just nondiversifiable risk, and that this approach protects other firm participants but is too risk averse from the shareholders’ perspective).

19. See Partnoy, *supra* note 14, at 600 (observing more broadly that “[f]or the study and practice of corporate law, the consequences of the derivatives revolution are devastating Some basic corporate law concepts, including the notion that managers should owe fiduciary duties to shareholders, rest on a shaky foundation at best”).

project that has a fifty percent chance of producing six million dollars in profits, and a fifty percent chance of producing a twelve million dollar loss. The project accordingly has a negative expected value of minus three million dollars. Although pursuing the project would reduce the economic value of the firm as a whole, under a rule of strict shareholder primacy, the directors of the company should proceed with the project. After all, viewed strictly from the shareholders' perspective, the project actually has a positive net expected value of half a million dollars.²⁰

B. How Recognizing Firm-Specific Investment Undermines the Principal-Agent Model

By revealing how debtholders, like shareholders, bear some residual risk in the firm, options theory demonstrates an important reason why shareholder primacy can be inefficient. But a strict rule of shareholder primacy carries even more potential for inefficiency than the above example suggests. This is because shareholders and debtholders are not the only groups whose fortunes are influenced by directors' decisions. To the contrary, a number of other groups can also be "residual claimants" of the public firm, in the sense that the value of these participants' economic claims on the firm depend, explicitly or implicitly, on the firm's overall performance.²¹

The point is perhaps most obvious in the case of managers and employees. Managers and employees frequently make firm-specific investments that give them a stake in the economic health of the firm. For example, employees and managers often make large investments in firm-specific human capital, such as knowledge, skills, and relationships, that are of far greater value to their present employer than to any other.²² Employees

20. The shareholders have a fifty percent chance of enjoying a six million dollar increase in the value of their equity, and because any loss over five million dollars would be borne by the debtholders, a fifty percent chance of only a five million dollar loss.

21. See, e.g., BLAIR, *supra* note 4, at 229-34; Blair & Stout, *supra* note 3, at 250, 275-78; Gulati et al., *supra* note 14, at 918-29; Bernard S. Black, Corporate Law and Residual Claimants 7 (May 2001) (working paper, on file with authors).

22. Employees laid off through plant closings or other corporate restructuring activity not only suffer loss of income while they search for a new job, but also typically take a cut in pay of at least ten to fifteen percent at their next job. See BLAIR, *supra* note 4, at 265-66 (discussing this phenomenon and citing empirical literature). As a rule, the longer the employee's employment with the previous firm, the larger the wage loss. For employees who have been at their previous job for ten years or more, losses generally exceed twenty-five percent. See generally Lori G. Kletzer, *Job Displacement*, 12 J. ECON. PERSP. 115 (1998) (presenting a comprehensive survey of empirical findings on economic losses due to job displacement). Though employees may eventually catch up in absolute terms to their former wage levels, the evidence suggests that, on average, these losses are, for practical purposes, never made up in relative terms. See Charles L. Schultze, *Has Job Security Eroded for American Workers?*, in THE NEW RELATIONSHIP: HUMAN CAPITAL IN THE AMERICAN CORPORATION 28, 56-59

and managers may also make firm-specific investments by putting forth extra effort to benefit the firm.²³ Employees and managers usually make these investments because they believe that in the long run, the firm will reward them with raises, promotions, and job security. However, while the belief that they will share in the firm's success can spur greater effort and loyalty from managers and employees, such an expectation is often legally unenforceable.²⁴ Managers and employees, as a result, run the risk that a reversal in the firm's fortunes might prevent the firm from ever giving them their expected raises and promotions. Indeed, if a risky corporate strategy ends badly, managers and employees might even be laid off, in which case they would lose their firm-specific human capital without any compensation. Employees and managers are also vulnerable to the possibility that a board of directors concerned only with shareholder interests might deliberately renege on their implicit commitments to employees.²⁵

Consider the example of a firm that induced its employees to make significant investments in firm-specific human capital through a legally unenforceable understanding that if the firm does well, the employees will receive regular raises. Assume the firm has annual sales of \$110 and pays annual wages totaling \$100, so that annual net earnings are \$10. These earnings are distributed as dividends to the shareholders each year and the market capitalization of the firm's equity is \$100, implying a price-earnings (P/E) ratio of ten to one. Assume also that the employees of the firm receive a wage premium of \$10 (somewhat more than ten percent) more than they could expect to earn if they were forced to find other employment. The premium is significant, because it implies that the firm could take advantage of the employees' firm-specific human capital investments by lowering its total annual wages from \$100 to \$90, and the employees would still be better

(Margaret M. Blair & Thomas A. Kochan eds., 2000) [hereinafter THE NEW RELATIONSHIP].

23. Such extracontractual investments are "firm-specific" in the sense that the employee cannot withdraw them and expect to be rewarded for them primarily by her present employer.

24. See generally Oliver E. Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LITERATURE 1537, 1543-47 (1981) (discussing the reasons for contract incompleteness); Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1763-65 (1989) (discussing contract incompleteness). See also *infra* text and notes 34-38 (discussing the difficulties of contracting in complex corporate production).

25. Even directors who are committed to shareholder primacy must be concerned about their firm's reputation in a particular labor market if they expect the firm to hire new employees from that market in the future. Reputational concerns alone, however, cannot deter opportunistic behavior in "endgame" situations where an employer either does not expect to hire new employees in the future or expects to hire them from a different market. Reputational constraints are thus greatly weakened when corporations are rapidly merging, spinning off, restructuring, moving production abroad, or otherwise transforming their identities.

off staying with their present employer.²⁶ If the board in fact lowered wages to \$90, this reduction in employee wages would trigger a *one hundred percent increase* in net earnings. If the firm's P/E ratio stayed constant the result would be to double the value of the shareholders' interest in the firm—at the employees' expense.

As this example illustrates, managers and employees of public firms also can have an economic interest (sometimes a very large economic interest) in how the directors of a public corporation decide to run the firm. Depending on the circumstances, similar arguments can be made about suppliers, contractors, customers, and even communities—indeed, any group that makes itself vulnerable by making investments specific to the corporation that are not completely protected by an enforceable contract.

C. On the Puzzling Persistence of Shareholder Primacy

An economic analysis of the public corporation in light of options theory and the phenomenon of firm-specific investment suggests that a strict rule of shareholder primacy can be inefficient. Focusing solely on increasing the value of the shareholders' interests can drive corporate directors to adopt strategies that decrease the aggregate value of the firm, once the economic value of nonshareholder interests is taken into account.

It seems curious, therefore, that contractarian corporate scholars (who generally favor efficiency as a policy goal) so frequently adopt shareholder primacy as if it were the only logical outcome of contractarian analysis. One possible explanation may be that the contractarian fondness for shareholder primacy is the legacy of an earlier economic literature that implicitly assumed that the relationship between shareholders and corporate managers was a principal-agent relationship.²⁷ Subsequent legal scholarship built on this early foundation without stopping to consider whether principal-agent analysis really offered an accurate description of the legal status of shareholders or the economic realities of the firm. But as we explore below, one can adopt a contractarian analysis and still reject the claim that the

26. As an empirical matter, a ten percent premium seems quite realistic. See sources cited *supra* note 22 (discussing how senior employees who lose their jobs through no fault of their own usually suffer significant decreases in lifetime earnings).

27. 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). These theoretical essays analyzed corporations in terms of a principle-agent analysis, thereby providing the basis for early contractarian corporate law scholarship.

principal-agent contract is the sole, or even primary, economic problem addressed by corporate law.²⁸

A second possible explanation may lie in corporate scholars' habit of looking at corporations through the lens of accounting. Income statements provide periodic snapshots of the flow of certain types of assets in and out of a firm over a specific period of time, and balance sheets capture a measure of the value of certain types of assets and liabilities at the end of that period. Ostensibly, these reports offer insight into the "net worth" of the corporation—the amount that would be available to pay out to the shareholders if the firm could instantaneously wind up its business, liquidate its assets, and pay off all its senior contractual obligations to employees, debtholders, and so forth. Accounting, however, notoriously fails to measure a wide range of matters that are relevant to valuing the corporation as a going concern.²⁹ For example, balance sheets and income statements offer little insight into the risks associated with the returns from particular corporate projects, even though (as options theory demonstrates) risk is critical to measuring economic value. Similarly, contemporary accounting conventions fail to measure many of the firm's important intangible assets and liabilities, such as the value of employees' firm specific human capital,³⁰ or the implicit obligations associated with many employees' expectations (expectations often encouraged by managers) that if the firm does well, capable employees

28. The mediating hierarch model we discuss here is contractarian in spirit, but it specifically rejects principal-agent analysis as the best way of modeling the core problem addressed by corporate law. The model argues instead that the central contracting problem in many business enterprises is the team production problem. *See infra* text accompanying notes 33-40.

29. A third factor that may have contributed to the notion that shareholders are the only residual claimants of firms is the bankruptcy principle of absolute priority. This principle is supposed to ensure that, in the event of a liquidation of corporate assets through the bankruptcy process, shareholders only get paid something if there are assets left over after all contractual claimants are paid. This principle may be honored more in the breach than in practice, especially after the Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-1501 (1994). Under Chapter 11 of the Bankruptcy Code, the debtor corporation may file for protection from creditors while it works out its problems, 11 U.S.C. § 1121 (1994), and the Code also permits a restructuring plan to be accepted by the bankruptcy court even if it does not follow absolute priority, if the plan is approved by a vote of the majority (representing two-thirds of the value of claims) of each class of claimants, 11 U.S.C. § 1126 (1994). Although bankruptcy law implicitly recognizes the importance of going concern value—this is the problem Chapter 11 was designed to address—any theory of the firm based on the assumed distribution of assets in liquidation obviously fails to include going concern value. When one considers the additional assets and liabilities associated with a going concern, it becomes clear that the only cases in which shareholders can properly be assumed to be the sole residual claimants in corporations are static, end-game scenarios, such as liquidation, and even then only if absolute priority is enforced.

30. *See generally* MARGARET M. BLAIR & STEVEN H. WALLMAN, UNSEEN WEALTH: REPORT OF THE BROOKINGS TASK FORCE ON INTANGIBLES (2001) (discussing implications for public policy of the growing importance of intangible assets in the U.S. economy); BARUCH LEV, INTANGIBLES: MANAGEMENT, MEASUREMENT, AND REPORTING (2001) (quantifying the role played by intangible assets in value creation in corporations).

will be rewarded with raises, promotions, and job security.³¹ As a result, so long as the firm remains a going concern, the present value of the wealth it creates, destroys, or redistributes to various corporate participants may be far greater, or far less, than the income statements and balance sheets show. Moreover, nonshareholder interests are likely capturing a substantial portion of this unseen and unreported wealth.³²

IV. TEAM PRODUCTION ANALYSIS AND DIRECTORS' ROLES AS MEDIATING HIERARCHS

As the discussion above suggests, a careful inspection of the economic realities of corporations reveals that, as an empirical matter, shareholders will almost never be the sole residual claimants or sole residual risk bearers in a public firm. Creditors, managers, employees—even suppliers, customers, and communities—also make firm-specific investments that tie their economic fortunes to the firm's fate. Moreover, because shareholders enjoy limited liability, their interest in the firm has option-like characteristics, and they can benefit from strategies that increase risk (much of the cost of which is borne by other claimants). Accordingly, there is good reason in economic theory to question whether a shareholder primacy rule would be economically efficient.

But the observation that nonshareholder groups also bear residual risk and hold residual claims in public firms has a second important implication: principal-agent analysis may be insufficient for analyzing the central problems of corporate law. Put differently, the typical public corporation involves several groups with potentially conflicting interests, each of which might legitimately claim to be a corporate “principal”.³³ Corporate

31. Although such factors have always been important in measuring long-term value, there is reason to believe that in recent years intangibles have outstripped physical assets in terms of their importance to corporate wealth creation. The market capitalization of publicly traded corporations in the United States is now several times larger than the value of the assets recorded on balance sheets. See LEV, *supra* note 30, at 9 fig. 1-19 (showing the ratio of market value of equity to book value of equity of Standard & Poors 500 firms was more than six to one as of year 2000); Robert E. Hall, *The Stock Market and Capital Accumulation 4* (1999) (Nat'l Bureau of Econ. Research, working paper no. 7180) (concluding that the discrepancy between the market value of corporate securities and the replacement cost of physical assets was so large at the end of 1998 (more than two to one) that it could only be explained by assuming that corporations had large amounts of intangible assets not being measured in the national accounts). There is no way to estimate what portion of the total value of intangibles captured in corporate security prices is attributable to firm-specific human capital.

32. Asset specificity is different conceptually from intangibility, but many specific investments made by nonshareholders (such as investments in relationship building and specialized knowledge) are intangible and do not show up on the books as corporate assets.

33. Principal-agent analysis, at least as it is usually employed in the corporate literature, tends to be asymmetric—it focuses only on the possibility that the agent might opportunistically exploit the

production thus involves not only an agency contracting problem, but also a second type of economic contracting problem called the "team production" problem.

We use the phrase "team production" to refer to complex productive activity that requires multiple parties to make contributions that are to some extent both team specific³⁴ and unverifiable³⁵ to an outside party, such as a court. A third key attribute of team production is that the resulting output is nonseparable, meaning that it is impossible to attribute any particular portion of the result to any particular member's contribution. A team's output may be nonseparable because each member's contribution is necessary to the outcome,³⁶ or because each member's contribution is unobservable or so complex that it is impossible to estimate what the team's output would be without that contribution.

These characteristics of team production make it extremely difficult for team members to design compensation contracts that provide adequate incentives for each team member to make optimal contributions to the team, whether those contributions take the form of dollars, ideas, or hard work.³⁷ For example, suppose the team members agree to divide up any surplus created by team production according to some prearranged formula, like "everyone gets an equal share of profits." Under such a rule, team members would be tempted to shirk on making any contribution that could not easily be verified, because they would bear all the cost of the contribution but get

principal, rather than on opportunism running in the other direction. The observation that corporations may require many different groups to make specific investments that leave them vulnerable to each other raises the alternative possibility of mutual opportunism.

34. Armen Alchian and Harold Demsetz may have been the first economists to use the expression "team production" to describe production requiring multiple inputs and producing a nonseparable output. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972). See also Bengt Holmstrom, *Moral Hazard in Teams*, 13 BELL J. ECON. 324 (1982). Alchian and Demsetz did not, however, address the additional contracting problems created when team production requires team-specific investment. Recently, Raghuram Rajan and Luigi Zingales addressed this additional problem, although they do not employ the rubric of "team production." See Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECON. 387 (1998) (discussing contracting solutions in team-like situations in which participants must make investments that are specific to the enterprise).

35. Actions by various participants in a corporate enterprise may be "observable" by other participants, but not subject to verification by a third party. Many "intangible" investments, for example, cannot be measured in ways that are subject to audit. Agreements to make such investments consequently cannot be regulated by contract because they are not enforceable by a court of law.

36. Economists normally assume that workers are paid according to their marginal contribution to production. But suppose it takes two people working together to move a piano up a flight of stairs. If either person quits, the other cannot do it by himself. It is meaningless in such a situation to speak of the "marginal contribution" of either worker. Both are necessary to do the job.

37. For a discussion of various proposed contracting solutions and their real-world analogies and problems, see Blair & Stout, *supra* note 3, at 265-69.

back only a portion of the resulting increase in surplus.

Yet if the team members do not decide in advance who is to get what, and the team is successful, they run into a second problem. Because the resources they invested often cannot be recouped once team production has begun (e.g., time, energy, ideas, or financial capital spent on wages or specialized equipment), team members cannot protect their interests by threatening to withdraw these resources and sell them to some third party in the marketplace. Team members can instead only get a return on their investment if they get a share of the team's output. Without an *ex ante* agreement about how to divide that output, each team member has an incentive to try to claim the largest share possible. Thus any surplus created by team production may be dissipated quickly through the squabbling and "rent-seeking" that results.

Corporations provide a classic example of team production. In order to earn profits from producing and selling goods and services, corporations need investors and lenders to provide financial capital, as well as entrepreneurs, managers, and employees to provide ideas, expertise, and labor. Once such resources are invested in the firm, they often become, at least in part, specific to the firm, in the sense that they do not have much if any value in the external market. The resources' value therefore depends on whether or not the project is successful. Moreover, while some portion of these contributions can be quantified (like the dollars lenders invest and the hours managers put in) other components (such as the risk lenders bear and the quality of managers' efforts) are far more difficult for an outside party, such as a court, to measure.

Consider the simple example of an entrepreneur who has an idea for a potentially valuable type of software. Since the entrepreneur needs money to develop her idea, she teams up with a financier. Both parties are aware that the joint venture may produce great profit, but both also recognize that any investment they make will swiftly become, in part, team specific. The financier cannot easily recover the full value of her investment once it has been spent on salaries and specialized equipment, just as the entrepreneur cannot recover her time and effort. Both must wait and hope that the project succeeds in order to receive a return. In the meantime, the reality of a complex and uncertain business environment makes it difficult for them to draft enforceable contracts that detail their contributions. How can they determine in advance when the financier should be required to invest more capital, and when he will be justified in pulling the plug? How can they specify when the entrepreneur's efforts qualify for her to receive a bonus, and when she should be fired? Of course, the parties could wait to see how the venture turns out before deciding who gets what share of the profit or

loss. If they wait, however, they are likely to lose valuable time and resources squabbling with each other, with no obvious solution.

Such contracting problems, if left unsolved, can discourage potentially profitable team production from taking place. A new solution to the team production contracting problem has emerged in economic theory in recent years, however.³⁸ In brief, this solution requires the team members to jointly agree to give up control over their team specific inputs and over any surplus that results from team production, and to cede this control to a neutral third party. This third party, whom we refer to as a mediating hierarch, decides who receives what share of the surplus.³⁹ Ideally, the hierarch does this with an eye toward maximizing the total surplus, while ensuring that each team member receives a large enough share to induce her to invest optimally in team production in the first place. Of course, for this solution to work, it is essential that the hierarch remain free from the command and control of any of the team members.⁴⁰

In a recent article, we proposed that the idea of a mediating hierarch may be essential to understanding the economic and legal functions of the corporate board of directors.⁴¹ Let us return to the example of the entrepreneur and the financier. This time, let us also bring into the equation a neutral outsider whom both sides trust to make judgments about each side's efforts and to allocate the resulting rewards. If they can find such a third party, the entrepreneur and the financier might be willing to pursue their project—provided that the third party is given the ultimate right to decide any conflict over the division of the surplus. In this fashion, the team members solve the team production contracting problem and discourage mutual rent-seeking by agreeing to subject themselves to a mediating hierarch who will monitor their efforts and decide how to divide the spoils.

38. See Rajan & Zingales, *supra* note 34.

39. This solution implicitly assumes that team production inputs need not be verifiable by a court, see *supra* text and note 35 (discussing verifiability), in order to be monitored and rewarded by the hierarch. In the corporate context, it seems quite plausible that a board of directors would have a far more accurate understanding than a court would of the relative contributions made and rewards due to various corporate participants. See Linda Keslar, *The Architect*, Feb. 13, 2001, at <http://www.law.com> (quoting former Delaware Chancellor William Allen that “the board has all the information and the courts don’t”).

40. It is also important that each team member believes the hierarch will provide enough of a share of the surplus that the member will get a greater return on investing in team production than in competing projects. See Blair & Stout, *supra* note 3, at 279.

41. *Id.* The idea of resolving problems of mutual opportunism by ceding control to a third-party hierarch is actually something of a standard move in legal theory. In a sense, this is what litigants ask judges to do, and there is a long tradition in political theory dating back at least to Hobbes that suggests such a role for a coercive state. See THOMAS HOBBS, *LEVIATHAN* 168-69 (Richard Tuck ed., Cambridge Univ. Press 1968) (1651).

In a public corporation where no single shareholder or group of shareholders owns a controlling block of shares, the role of the mediating heirarch can be played by the board of directors. In fact, recent empirical evidence suggests that this mediating role is exactly what many corporate promoters seek from the board when they cause the corporation to “go public.” Academic studies of firms planning an initial public offering show that even though outside investors (e.g., venture capital firms) may often hold majority blocks of stock, at the time the firm goes public the board is structured so that neither the block investors nor the firm’s founders make up a majority of the seats on the board.⁴² “Independent” directors who are neither part of management, nor representatives of the venture capitalists, typically hold enough votes to determine the outcome in any dispute between the entrepreneur and the venture capitalist. In a recent working paper, Stephen Choi argues that this structure is designed to reassure the firm’s entrepreneurs and employees on the one hand, and its contributors of financial capital on the other, that neither side can readily manage the firm in a fashion detrimental to the other.⁴³ Choi further concludes that the likelihood that a firm going public would adopt this “contestable” board structure correlates with several proxies for managers’ firm-specific investment.⁴⁴

The mediating hierarchy model is similarly supported by empirical studies finding that approximately two-thirds of firms adopt some sort of antitakeover provisions before they go public.⁴⁵ If antitakeover provisions simply give directors leeway to allow managers to impose agency costs inefficiently on shareholders, this strategy makes little sense because it reduces the economic value of the firm as measured by the investing public’s willingness to pay for its equity shares.⁴⁶ The adoption of antitakeover provisions at the initial public offering stage makes sense, however, as a means of encouraging team production by reassuring the firm’s managers and employees that their futures rest in the hands of the board of directors, rather than with shareholders who might be tempted to sell them out in the “market for corporate control.”⁴⁷

42. See Julia Porter Liebeskind, *Ownership, Incentives, and Control in New Biotechnology Firms*, in *THE NEW RELATIONSHIP*, *supra* note 22, at 299; Stephen Choi, *What Determines Board Composition? CEOs and Firm-Specific Investments in Human Capital* (2000) (working paper, on file with author).

43. Choi, *supra* note 42, at 2-3.

44. *Id.* at 2.

45. Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs 3-4* (2000) (working paper, on file with authors).

46. *Id.* at 2.

47. See *infra* text accompanying note 91 (discussing market for corporate control).

V. CORPORATE LAW SUPPORTS THE BOARD'S MEDIATING ROLE

Once we recognize that boards of directors can play a valuable mediating role among the several groups that may comprise residual claimants in a corporation, a variety of important aspects of corporate law that have proven difficult to explain under the principal-agent model of the firm begin to make sense. Although we have explored this idea in greater detail in our prior work,⁴⁸ below we briefly discuss some of the more central elements of U.S. corporate law that support the board's ability to serve as a mediating hierarchy, at least in publicly held firms. As will be seen, U.S. law grants directors tremendous discretion to adopt corporate strategies that enhance the value of nonshareholders' residual claims within the firm, even if these strategies decrease the value of shareholders' claims. For reasons we explore, this may well serve the interests of shareholders as a class over the long run. But it clearly does not serve the interests of every shareholder or shareholder group, at every firm, at all times. Thus corporate law in the United States (while perhaps more shareholder-oriented than corporate law in many other developed countries) comes closer to reflecting and supporting the mediating hierarchy view of the board's role, than it does a view of directors as shareholders' agents.

A. *Directors are Autonomous Fiduciaries, Not "Agents"*

Let us begin with the fundamental idea of the corporation as a legal entity. When a corporation is formed, a new legal being is born. As a matter of law, this entity, and not any of its participants, owns the assets used in corporate production, as well as any surplus produced by the enterprise. And as a matter of law, this entity (along with its assets and surpluses) is controlled not by any individual or group with a direct stake in its future, but by a board of directors made up of individuals who may have no economic interest in the firm at all.⁴⁹

These directors are not, in any legal sense, anyone's "agents."⁵⁰ Most

48. See Blair & Stout, *supra* note 3, at 276-87.

49. See *supra* note 1. Directors may also be shareholders or managers, in which case they may have a substantial economic stake in the firm in those capacities. See *infra* text accompanying notes 121-22 (discussing directors as shareholders) and n.87 (directors as managers). But as a matter of law, this is not required. Control over corporate assets can, accordingly, lie in the hands of individuals who have no direct economic stake in how those assets are used.

50. The point is perhaps most neatly summarized by Dean Robert Clark, who notes that under U.S. law:

(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

obviously, directors do not owe any duty of obedience to shareholders or to anyone else, as an agent would in a standard principal-agent relationship.⁵¹ While the directors enjoy ultimate control over the corporation's assets, including control over how those assets are used and how any surplus will be distributed, they are not subject to the direct control of any outside party. For example, suppose the shareholders want the board to fire the chief executive officer (CEO) or to declare a substantial dividend. Although they can present a proposal requesting such action, the board is free to ignore it.⁵² Corporate law does not permit shareholders to command the board to action even by a unanimous vote. This pattern makes little sense under a contractarian model of the corporation that treats directors as shareholders' agents.⁵³

The fact that the directors are not subject to any corporate participant's direct control does not mean, however, that directors are free to use this autonomy to promote their own interests. Rather than being agents, directors play a role that more closely resembles that of an autonomous trustee or fiduciary who is charged with serving another's interests. Thus numerous judicial opinions describe the director's role in fiduciary terms. Moreover, many of these cases explicitly observe that, as fiduciaries, directors owe their duties to the firm itself.⁵⁴

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.

Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* 55, 56 (John W. Pratt & Richard J. Zeckhauser eds., 1985).

51. See *RESTATEMENT (SECOND) OF AGENCY* § 385 (1958) (describing the agent's duty of obedience).

52. 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). This pattern is so well-established in corporate law that the federal rules regulating shareholder proposals allow directors to refuse to include in their proxy materials any proposal demanding that the directors take action as "not a proper subject for action by shareholders." *Shareholder Proposals*, 17 C.F.R. § 240.14a-8(i)(1) (2000). To prevent exclusion, the proposal must be recast as a recommendation rather than a demand. See generally *SOLOMON ET AL.*, *supra* note 8, at 601 (describing federal shareholder proposal rules and requirement that proposal be precatory rather than mandatory).

53. One could, perhaps, defend insulating directors from the dictates of a majority of the shareholders under a rule of shareholder primacy on the grounds that this helps to protect minority shareholders. In effect, this approach suggests that directors are mediating heirarchs—that they only mediate disputes among shareholders. This argument cannot, however, explain why directors are free to ignore a *unanimous* shareholder request.

54. See, e.g., *United Teachers Associated Ins. Co. v. MacKeen & Bailey, Inc.*, 99 F.3d 645, 650-51 (5th Cir. 1996) (director owes fiduciary duty "to the corporation"). See also *RESTATEMENT (SECOND) OF AGENCY* § 14C cmt. a (1956) (stating that directors owe duties to "the corporation itself rather than to the shareholders individually or collectively"). Other cases describe directors' duties as running to the "firm and its shareholders," a phrase implying the two terms are not synonymous. See, e.g., *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1988) ("[T]he board of

This pattern makes sense under a model of corporate law that views the board as a mediating hierarch overseeing team production. Using team analysis, the “firm” can be understood as a nexus of firm-specific assets that have been invested by a variety of groups, including most obviously shareholders, bondholders, managers, and employees. The board of directors acts as a fiduciary for the firm, meaning that it seeks to maximize the total value of these combined economic interests.⁵⁵ In order to do this, it is essential that the board remain free from any single group’s control.

Of course, in saying that the board “controls” the firm, we do not intend to suggest that the individual members of the board actually run the business on a day-to-day basis. Although they have the collective power to do so, in most large firms the directors delegate this task to executive officers and employees, who are true agents of the firm in a legal sense. Moreover, having taken the trouble to appoint professional managers, it is logical that most boards will then tend to defer to their agents’ expertise, sometimes to the extent of appearing to simply “rubber stamp” the CEO’s decisions. But this pattern should not obscure an important corporate reality—legally, it is the board that hires the CEO, not the other way around.⁵⁶ Increasingly, it is also the board that fires the CEO—a practice so common that the cover of *Business Week* recently trumpeted that CEOs are “dropping like flies.”⁵⁷

In other words, it is the board, and not the professional managers, that retains the power to control major decisions in most large firms, including decisions about when shareholders are paid dividends and what the managers’ compensation should be (two issues of special importance in determining the allocation of team surpluses). The corporate buck stops not

directors owe fiduciary duties of care and loyalty to the corporation and its shareholders.”); *Unocal Corp. v. Mesa Petroleum Co., Inc.*, 493 A.2d 946, 954 (Del. 1985) (“[T]he board’s power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm.”). See also Blair & Stout, *supra* note 3, at 293-94 & nn.105-06 (discussing the question).

55. See Blair & Stout, *supra* note 3, at 288. See also Eric Talley, *Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine*, 108 YALE L.J. 277, 319-22 (1998) (noting that while the law and economics literature tends to focus on share value as the standard of success in corporations, the notion of “optimality” of corporate contracts has at least two possible meanings: one is that shareholder value is maximized; the other is that the joint wealth of shareholders and other participants is maximized).

56. This is especially clear in the case of firms where a majority of the board is made up of outside directors who are not employees of the company, a category that includes seventy percent of the largest 1,000 or so U.S. corporations. See John C. Coates IV, *Measuring the Domain of the Mediating Hierarchy: How Contestable are U.S. Public Corporations?*, 24 J. CORP. L. 837, 844-45 (1999). See *infra* notes 75-76, 86-80 (discussing boundaries of mediating model).

57. Anthony Bianco & Louis Lavelle, *The CEO Trap*, BUS. WEEK, Dec. 11, 2000 (on the cover page). See also *id.* at 86 (noting that two-thirds of all major companies replaced their CEO at least once in the past six years).

in the corner office but in the boardroom. This is likely to be true, moreover, even when the board appears to play a relatively passive role. After all, once a trusted heirarch is in place, team members will often be able to reach agreement among themselves about who contributes what and who gets what, because they know that excessive shirking or rent-seeking is likely to get “kicked upstairs” for board review. Directors do not need to take an active role in firm decisionmaking to discourage opportunistic behavior among corporate team members, any more than police officers need to operate all the vehicles on the highway to discourage speeding.

What clearly *is* required for the board to perform a mediating role, however, is a significant degree of freedom from the control of the members of the corporate “team”—including the shareholders. Thus, we briefly address below two aspects of corporate law that, on first inspection, appear to give shareholders significant control over the board: derivative suits and shareholder voting.

B. The Role of Derivative Actions

If a director violates the fiduciary duties she owes the firm, other members of the board have both the authority and the responsibility to take legal action against her on the corporation’s behalf. Situations arise, however, in which the directors as a group are subject to potential liability, or are reluctant to initiate a lawsuit against a fellow board member. Recognizing this reality, corporate law generally permits shareholders to “step into the shoes” of the corporation in such circumstances by bringing a derivative suit on behalf of the corporation.⁵⁸

Corporate law normally grants standing to bring a derivative suit only to shareholders and not to other corporate participants.⁵⁹ This right should not, however, be interpreted to mean that directors owe fiduciary duties only to

58. *See generally* ROBERT CHARLES CLARK, CORPORATE LAW 639-64 (1986) (describing derivative suits).

59. Corporate law allows bondholders and other creditors to bring claims of breach of fiduciary duty against the board if the corporation is at or near insolvency. *See Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613, at *3 (Del. Ch. Dec. 30, 1991) (discussing doctrine and approving action of board that protected creditor over protest of a 98.5 percent shareholder, and noting that, at least when the corporation is operating in the vicinity of insolvency, the board is not merely the agent of the shareholders as residual risk bearers but owes its duty to the corporate enterprise as a whole). This suggests that shareholders are normally permitted to bring such suits primarily because shareholders’ interests are usually a reasonable proxy for the interests of the corporation as a whole. If a company is, however, at or near insolvency, shareholders’ preference for risky strategies may make them poor representatives for other participants in the firm. *See also supra* text accompanying notes 17-20 (discussing options theory and firm risk). At this point the law grants standing to other constituencies, notably creditors.

shareholders. Any judgment won in a derivative suit must be paid to the corporation and not the shareholders.⁶⁰ More important, careful inspection of the substantive nature of directors' fiduciary duties reveals that shareholders can only bring a successful derivative suit in circumstances where directors act in a fashion that hurts not just shareholders, but other residual claimants as well.⁶¹

This point is perhaps best illustrated in the case of a suit alleging breach of a director's duty of loyalty to the firm. The duty of loyalty prohibits directors from various forms of self-dealing, including prohibiting them from taking a business opportunity or other property that belongs to the corporation.⁶² As a practical matter, courts tend to hold directors liable only in egregious situations involving a significant pecuniary benefit to the director or loss to the firm, and in which the offending director or directors failed to subject the self-dealing transaction to an informed vote by the disinterested directors or the shareholders.⁶³ As this description makes clear, the duty of loyalty works primarily to prevent directors from indulging in more blatant forms of theft. Because such theft reduces the economic value of the firm as a whole, it harms not only shareholders, but also bondholders, employees, and other residual claimants in the firm.

It is important to note, however, that directors will not be deemed to violate the duty of loyalty in transactions that simply transfer corporate wealth from one residual claimant to another, even when this benefits other corporate constituencies at the shareholders' expense. For example, directors do not violate their duty of loyalty when they protect creditors by avoiding risky strategies that would benefit the shareholders,⁶⁴ or when they contribute corporate funds to charitable organizations.⁶⁵ This is true even though transactions that benefit other corporate constituencies may also provide nonpecuniary benefits to the directors themselves. For example, directors may cause the corporation to make donations to charities they favor personally. Similarly, directors can reject risky but potentially profitable

60. The cash will only end up in the shareholders' hands if a dividend is subsequently paid, and, of course, directors control the decision to pay dividends. *See* CLARK, *supra* note 58, at 594 (noting that decision to pay dividends is a matter for the directors' business judgment). Procedural rules, moreover, make it difficult for shareholders to file derivative actions and so tend to insulate directors even from this form of shareholder challenge and control. *See* Blair & Stout, *supra* note 3, at 294 n.107 and surrounding text for more detail on these procedural rules.

61. *See* Blair & Stout, *supra* note 3, at 298.

62. *See generally* CLARK, *supra* note 58, at 141-57 (describing the duty of loyalty).

63. *Id.* at 141, 167.

64. *See, e.g.*, Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 WL 277613, at *3 (Del. Ch. Dec. 30, 1991).

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

business strategies, an approach that benefits the firm's creditors but also increases the likelihood that the corporation will stay in business and the directors will keep their positions.⁶⁶

A similar analysis can be applied to cases alleging breach of the duty of care. In theory, the duty of care requires directors to manage the firm with the care of a reasonably prudent person. In practice, this standard is modified by the "business judgment rule," which protects directors from liability provided they are free of personal conflicts of interest and make the effort to act in an "informed" fashion.⁶⁷ This focus on procedure ensures that duty of care cases can only be brought in circumstances where the interests of all the corporation's residual claimants are served. After all, bondholders, managers, and employees share the stockholders' interest in ensuring that the board does not take hasty, uninformed action.

If the board follows proper procedures, however, it remains free to take actions that protect other corporate constituencies while reducing the value of the shareholders' economic interest in the firm. For example, directors can unilaterally raise retirees' pension benefits,⁶⁸ refuse to adopt a corporate strategy that would increase profits but harm the local community,⁶⁹ and fend off a hostile takeover bid at a premium price in order to protect the interests of the firm's employees, the local community, or the firm's "culture".⁷⁰

Critics of the team production approach point out that, in upholding such director action, courts sometimes rationalize that the board serves the shareholders' interests "in the long run."⁷¹ As we discuss below, because the

66. Clark has called such action[s] "corporate action[s] with mixed motives." See CLARK, *supra* note 58, at 142. See generally Margaret M. Blair, *A Contractarian Defense of Corporate Philanthropy*, 28 STETSON L. REV. 27 (1998) (using team production analysis to defend directors' legal discretion to use corporate funds for charitable purposes).

67. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). See generally CLARK, *supra* note 58, at 123-40 (discussing the duty of care and the business judgment rule).

68. See, e.g., Ellen E. Schultz & Matt Murray, *Amid Protests, GE Will Boost Pension Checks*, WALL ST. J., Apr. 18, 2000, at A3 (reporting that following demonstrations by retired employees, General Electric announced a pension increase of fifteen to thirty-five percent for employees who retired before 1986).

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

70. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (noting that in deciding whether a takeover posed a threat to "the corporate enterprise," directors could take account of the impact on nonshareholders, including "creditors, customers, employees, and perhaps even the community generally"); *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964) (describing how the directors of the Holland Furnace Company fended off a hostile acquirer, in part, to protect employees); *Paramount Communications v. Time, Inc.* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989) (describing and upholding decision of directors of Time to reject Paramount's premium offer in order to pursue a merger that would preserve "Time[']s culture" of journalistic integrity). The obvious exception to this last rule is the *Revlon* case. See *infra* text accompanying note 75.

71. A recent essay by David Millon and a working paper by Alan Meese critique the mediating

institution of a board of directors insulates other corporate residual claimants from shareholder opportunism to some degree, it can encourage profitable team production that otherwise would not take place. Thus granting directors broad autonomy may indeed serve the interests of shareholders, both as a class and in the long run. But it also clearly disserves the interests of some firms' shareholders, at some times.

For a striking example of this, one need look no further than the Delaware Supreme Court's notorious decision in *Paramount Communications, Inc. v. Time*.⁷² In that case, the court upheld a decision by the board of Time, Inc. to reject a \$200 cash per share takeover bid by Paramount, in favor of pursuing a merger with Warner Communications in which the Time shareholders would receive securities trading at a market price of \$125 per share. In other words, the court found that a decision reducing the immediate market value of the Time shareholders' interests by thirty-five percent did not violate the directors' duties of loyalty or care.⁷³ The court defended this holding on the grounds that it is the job of the directors, and not of the shareholders, to decide what course best served the interests of the firm and its shareholders in the "long term."⁷⁴

As the *Time* decision illustrates, by mouthing the rhetoric of the long run, courts can freely approve director actions that reduce the value of the shareholders' interests today. Director decisions to reallocate resources from shareholders to other corporate constituencies thus are largely insulated from shareholder challenge—at least as long as the public corporation remains in existence, so that there is a "long run" to appeal to.

This observation helps explain the only situation where Delaware courts require directors to maximize the value of a firm's shares: when a firm is

hierarch model on the basis of this rhetoric. See David Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001 (2000); Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment* (2001) (working paper, on file with author).

72. 571 A.2d 1140 (Del. 1989).

73. The only way such a decision could be consistent with shareholder primacy and market efficiency is if the court believed that Time's directors had access to private information indicating that the Warner merger would soon produce tremendous benefits that eventually would be incorporated into the market price and raise it above the Paramount offer. See *supra* note 6 (discussing market efficiency). See generally Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: Sacred Space and Corporate Takeovers*, 80 U. TEX. L. REV. (forthcoming 2001) (implicitly adopting this argument while noting that director discretion can also be used to protect other constituencies). But if this possibility is what the court intended to suggest, subsequent events did not support such a prediction. More important, by allowing the directors to argue that a strategy of reducing shareholder value today would actually enhance shareholder wealth tomorrow, the court implicitly granted the board discretion to favor nonshareholder interests.

74. *Time Paramount Communications*, 571 A.2d at 1150.

about to be sold to a controlling shareholder or group of shareholders, and so about to cease being a “public” firm at all. Under the doctrine espoused in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,⁷⁵ when a public firm is about to “go private,” the board must do its best to maximize the price the shareholders receive for their shares. This is an end-game scenario, however, in which the public shareholders are about to be squeezed out of the corporate “team”. Hence it makes sense for the court to grant the shareholders special protections.⁷⁶

In contrast, so long as the directors intend to maintain the public corporation as a going concern, team production is better protected by ensuring that no single corporate constituency can use the threat of a derivative suit to force the board to favor their particular interests over other team members’ interests. In accord with this, corporate law provides that neither the duty of loyalty nor the duty of care precludes directors from aiding other corporate constituencies at the shareholders’ expense. This result seems peculiar indeed under a principal-agent model of the firm that views directors’ fiduciary duties as running to shareholders alone. It is consistent, however, with the mediating hierarchy model and the idea that the directors’ role is to prevent or discourage corporate participants from attempting to exploit each others’ firm-specific investments, by taking control of those investments and the resulting surplus out of the participants’ hands and placing it in the hands of a board of directors.⁷⁷

C. The Role of Shareholder Voting and the Public/Private Firm Distinction

The discussion above suggests that while derivative suits on first inspection appear to give shareholders a power over directors that other corporate constituents lack, in practice, shareholders may only bring

75. 506 A.2d 173 (Del. 1986). *See also* *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994) (holding that *Revlon* applies when a firm is to be sold to a controlling shareholder); *Black & Decker Corp. v. American Standard, Inc.*, 682 F. Supp. 772 (D. Del. 1998) (holding that *Revlon* applies to a recapitalization in which management’s share ownership would increase from five to fifty-five percent); *compare* *Paramount Communications, Inc. 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 entity also would be publicly held).

76. *See* Blair & Stout, *supra* note 3, at 308-09 (discussing *Revlon* as an end-game scenario).

77. If shareholders or other corporate constituents could easily bring lawsuits against directors for breach of fiduciary duty, they might be tempted to use the threat of such lawsuits to persuade the directors to favor their interests over other groups’, and so seek rents from other participants in the corporate enterprise. This would undermine the ability of all team members to make credible *ex ante* commitments to discourage rent-seeking by ceding control over the joint enterprise to a mediating hierarch. Without such a credible commitment, investment in team production might not take place.

successful claims in circumstances where doing so is likely to serve other residual claimants' interests as well. In other words, shareholders cannot use derivative suits as vehicles for "rent-seeking" against other corporate team members. This argument does not apply, however, to a second unique right shareholders enjoy—the right to vote to elect and sometimes to remove directors, and to veto certain "fundamental" corporate changes such as mergers. Why does the law give shareholders voting rights when it does not usually grant other corporate participants this privilege?⁷⁸

In our prior work on team production theory, we suggested two possible answers.⁷⁹ The first is that shareholder voting is merely instrumental. Shareholders get to vote for directors for same reason that shareholders get to sue derivatively—someone has to choose the directors. As a group, moreover, shareholders in a public corporation may have more homogeneous interests (and so be less susceptible to coalitions, logrolling, and other voting pathologies) than other sorts of residual claimants, such as managers or creditors, whose interests are more diverse.⁸⁰ Finally, while shareholders' interest in maximizing the value of their shares may often conflict with the interests of other residual claimants, this is not always true. Many strategies that increase share value serve other groups as well. Thus, at least when its role is confined to selecting directors who will then be largely free from any single residual claimant's direct control, shareholder voting may be an acceptable, if imperfect, proxy for the preferences of the corporate team as a whole.⁸¹

A second possible explanation is that shareholders enjoy unique voting rights as a form of compensation for the unique vulnerabilities they suffer compared to other residual claimants.⁸² Especially in publicly held firms with widely dispersed share ownership, shareholders have almost no ability to enter explicit contracts with the firm and relatively little opportunity to interact directly with the board of directors, especially when compared with debtholders, employees, and managers. They have, as a result, few salient

78. See CLARK, *supra* note 58, at 94-95 (discussing shareholder voting rights). Nothing in corporate law prevents firms from adopting charters that provide for voting by other participants. For example, at UAL Corp. (the parent company of United Airlines), three employee groups (the pilots union, the mechanics union, and the nonunion employees) each control one seat on the board of directors. See Terry Savage, *United Airlines Anything But United: Some Wonder If Employee Ownership Has Become an ESOP Fable*, CHI. SUN TIMES, Aug. 10, 2000, at 56. Voting by nonshareholder constituencies, however, is relatively rare in the United States.

79. See Blair & Stout, *supra* note 3, at 309-15 (discussing the implications of the mediating hierarchy model for understanding shareholder voting rights).

80. *Id.* & 313 n.175.

81. *Id.* & nn.176-78.

82. *Id.* at 314.

opportunities to express their views—except at election time.⁸³ Giving shareholders unique but limited voting rights may be justified as a means of “leveling the playing field” so that shareholders can compete with other residual claimants in terms of their ability to capture the board’s ear.⁸⁴

Perhaps most important in explaining why shareholder voting does not destroy the board’s ability to act as a mediating hierarch, however, may be the tremendous difference between the role shareholder voting plays in public corporations, and the role it plays in privately held firms. In a privately held or “close” corporation, a single shareholder or group of shareholders holds a majority interest in the firm’s shares. Absent cumulative voting or some similar device, these controlling shareholders have the practical ability to select who will serve as directors and to remove directors who refuse to do their bidding.⁸⁵ This element of enhanced control suggests that directors’ ability to act as neutral mediators between shareholders and other groups (for example, employees and managers) in private firms may be limited. In other words, as suggested in our earlier discussion of *Revlon*, the mediating hierarchy model may not apply to the board of a closely held firm.⁸⁶

83. Indeed, the recent trend toward the adoption of equity-based compensation systems probably influences directors’ choices a great deal more than shareholders voting rights do. *See infra* text accompanying notes 120-22 (discussing equity-based director compensation).

The observation that shareholders have a difficult time contracting might support a reasoned argument for shareholder primacy if shareholders’ contracting problems are severe and other groups’ relatively insignificant. *See, e.g.*, Jonathan Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 188-92. At this point, however, the wisdom of shareholder primacy becomes an empirical question. If, as much evidence suggests, the contracting problems of nonshareholder groups remain substantial enough to discourage team production, *see supra* text accompanying notes 21-26, 34-38 (discussing employees’ residual interests), a mediating hierarch might be a better, albeit second best, solution. We suspect that the answer varies from time to time and from firm to firm. *See infra* text accompanying notes 86-88 (discussing public versus private firm distinction). We do not, however, object to shareholder primacy in any particular firm, but only a strict and unthinking rule that shareholder primacy is best in all firms.

84. This also may explain why shareholders enjoy the right to veto certain “fundamental corporate changes” such as mergers or dissolutions. Such changes present end-game problems similar to those involved in *Revlon*. *See supra* text accompanying note 75 (discussing *Revlon*).

85. Even for controlling shareholders, there are significant procedural hurdles involved in changing the board of directors. *See generally* CLARK, *supra* note 58, at 105 (discussing voting requirements of notice, a quorum, cause for removal, and so forth).

86. *See supra* text accompanying notes 75-76. This likely explains why shareholders in privately held firms in many states may choose to manage their firms directly rather than through an elected board. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 350-51 (2000) (describing special rules permitting shareholders in closely held firms to dispense with a board of directors).

An interesting question is what role directors play in firms in which a single shareholder or group of shareholders owns a large block of stock that falls short of a majority interest, thus falling somewhere between these two categories. For an excellent discussion of this question, see Coates, *supra* note 56. Coates questions the significance of the mediating hierarchy model given that many nominally “public” firms have shareholders who effectively control the firm through ownership of a large block of shares.

We do not mean to imply that team production does not pose contracting problems in private firms; it does.⁸⁷ Private firms, however, may rely primarily on mechanisms other than a neutral board to discourage shirking and rent-seeking among corporate participants. For example, controlling shareholders' tendency to also hold management positions in private firms does much to bring these two groups' interests into alignment. Similarly, privately held firms are usually much smaller than public corporations, and as a result, their employees may be more willing to rely on interpersonal trust as protection against shareholder and manager opportunism.⁸⁸

Shareholder voting plays a much different role in a public corporation with hundreds or thousands of stockholders. As noted earlier, shareholders in such firms can vote only to elect or remove directors, or to veto a limited class of fundamental corporate changes that the directors must first propose.⁸⁹ And, as a practical matter, shareholders are precluded from effectively exercising even these limited formal rights. Because informed shareholder voting is a public good, shareholders (like other voters) are prone to "rational apathy." The problem is worsened by the fact that communicating with one's fellow shareholders through the proxy process is notoriously difficult and expensive. In contrast, if an activist shareholder attempts to challenge the board through the proxy process, the directors enjoy access to the corporation's treasury in defending themselves in the ensuing

Coates concedes, however, that even under this very strict test, most large companies in the United States lack a shareholder who owns even thirty-five percent of outstanding shares. *Id.* at 848. Because we are not arguing that the mediating hierarchy model is the only contracting solution to team production (only that it is a very important one in many of the largest firms) this analysis is illuminating but by no means fatal. Coates also suggests that many U.S. public firms are not well described as having mediating boards because a majority of the board is made up of "insiders" who also serve as managers, or outsiders who are as a practical matter "dominated" by insiders. *Id.* at 844. We regard such firms, however, as still falling within the mediating hierarchy model. Once directors are elected they enjoy the power to shift resources from managers to shareholders. They may very well exercise this power if existing management is performing poorly and internalized norms of fiduciary behavior suggest they should. The high level of turnover in executive suites in the last decade, *see infra* text accompanying note 55, suggests directors will, indeed, take actions against existing management if they believe that shareholders are being treated so shabbily they are likely to exit the corporate "team", perhaps by selling into a takeover offer. *See infra* text accompanying note 91. Thus, while the fact that a majority of the board has ties to management likely allows managers to capture a larger share of the team's surplus than another arrangement might, it does not make team production analysis inapplicable.

87. In a recent working paper, Alan Meese critiques the mediating hierarchy model on the grounds that directors cannot play such a role easily in a closely held firm, and that closely held firms involve at least as much firm-specific investment as public companies. Meese, *supra* note 71. Although we agree with both of these propositions, we disagree with Meese's conclusion that they somehow undermine the mediating hierarchy model. As our discussion in the text explores, closely held firms can and likely do rely on other arrangements to protect firm-specific investment.

88. *See supra* text accompanying notes 104-07 (discussing altruism and trust).

89. *See supra* text and note 78 (discussing voting rights).

proxy battle. Moreover, the directors are empowered to set the date and the agenda for shareholder voting, and to propose their own slate of nominees, usually themselves, for the board. The net result is that, as a practical matter, the casting of shareholder votes in most public corporations is a meaningless rite.⁹⁰

There is an important caveat to this last observation. Shareholder voting can play an important role in determining who controls the corporation when a takeover bid is launched by an organized, wealthy, and dedicated suitor. Such a bidder might persuade the target firm's shareholders to sell voting control in a tender offer, or to oust their present directors in a proxy battle, by tempting them with the opportunity to sell their shares at a hefty premium. A full discussion of the intricacies of corporate takeovers lies beyond the scope of our discussion. However, even commentators who believe that the market for corporate control significantly constrains directors acknowledge that hostile takeovers—whether attempted through tender offers or proxy battles—are difficult, risky, and expensive.⁹¹ Shareholders' theoretical ability to "vote with their feet" in the market for corporate control thus seems likely to impose only a modest constraint on directors' ability to serve as mediating hierarchs to the collection of residual claimants that make up "the firm."

D. The End Result is Director Autonomy

Even this casual survey of U.S. corporate law reveals that the directors of public corporations enjoy remarkable discretion in deciding how corporate assets should be used and how corporate surpluses should be distributed. Should the firm close down a marginally profitable plant or keep it open in the interests of its employees and the local community? Should it retain earnings and build an empire for managers or should it use that money to pay out a hefty cash dividend to the shareholders? Should it increase its leverage and its return on equity or retain a comfortable cash cushion for the creditors?

90. Blair & Stout, *supra* note 3 (discussing limits on shareholder voting). *See also* CLARK, *supra* note 58, at 95 (noting that a cynic might conclude shareholder voting is "a fraud or a mere ceremony designed to give a veneer of legitimacy to managerial power"). These observations suggests a third possible explanation for shareholders' voting rights: shareholder voting may be customary in public corporations for path dependence reasons. Large, publicly held corporations are a relatively recent innovation in economic history. Before the early twentieth century, most corporate activity took place in closely held firms in which shareholders were actively involved managers who could not readily sell their interests. At that time, shareholder voting played a key role in resolving intrashareholder conflicts. As the public corporation evolved, the practice of shareholder voting persisted, even as its importance as a governance tool declined.

91. *See, e.g.*, Coates, *supra* note 56, at 850 (stating that "[a]dmittedly, the market for corporate control is 'lumpy' and expensive").

It is the directors who ultimately decide.

This is not to suggest that directors' discretion is entirely unfettered. Although directors enjoy remarkable freedom from shareholders' (or anyone else's) direct control, they remain subject to equity market pressures. They may, for example, want to raise capital by selling stock to public investors, or their compensation may be tied to share price performance. In such situations, directors would have a special incentive to pay attention to shareholders' interests in making their decisions.⁹² Nor do we intend to suggest that the board must, or should, ignore the shareholders' wishes. Shareholders are essential members of the corporate "team". But shareholders are not the *only* valuable team members who have a residual claim on the firm and whose interests thus need protection. Just as directors are free to listen (if not always to respond) to the shareholders' wishes, they are free to listen (if not always to respond) to the wishes of creditors, top executives, and rank and file employees.⁹³ Similarly, just as directors need to worry about equity market pressures, they need to worry about the pressures of other markets, including credit and employment markets.

Still, there remains enough "play in the joints" to allow directors to favor one corporate constituency's interests over another's to a significant extent in many situations, without fear of serious consequences.⁹⁴ So long as the

92. It should be noted that seasoned equity issuances by public corporations are relatively rare, and many other sources of capital are available. See Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 644-50 (1988) (discussing the relative unimportance of equity issues as a source of corporate capital).

93. Henry Hansmann and Reinier Kraakman have suggested that the team production model is one of several "reformulations of the manager-oriented model," see Hansmann & Kraakman, *supra* note 3, at 448, which, in turn, is a "failure". See *id.* at 443. Because we believe U.S. corporate law leaves directors of public firms just as free from top executives' control as they are from shareholders', we believe it is inaccurate to describe the mediating hierarchy model as managerialism. We also note the lack of rigorous evidence that the managerial model is a failure, except for the single observation cited by Hansmann and Kraakman that corporations in common law jurisdictions (primarily the United States and other English-speaking countries) have performed better in general than corporations in other countries in recent years. *Id.* at 450. Since we do not agree that U.S. corporations actually operate in a legal environment that enforces shareholder primacy, see *supra* text accompanying notes 48-91, we do not view this observation as evidence for the proposition.

94. See Millon, *supra* note 71, at 1003 (noting that corporate law may allow "enough 'play in the joints' to accommodate a board that seeks to act as mediator"). Millon goes on to critique the mediating hierarchy model on the grounds that nonshareholder groups are not completely protected by legal rules that give directors this much discretion. See *id.* at 1003-04 (noting that while directors are free to act as mediators, corporate law "does not mandate that vision and is equally capable of accepting director commitment to shareholder wealth maximization"). See also Meese, *supra* note 71. We agree. The specific investments of managers, employees, creditors, and other nonshareholder participants are not absolutely protected by mediating directors, just as shareholder claims are not absolutely protected by this arrangement. We believe, however, that all the participants are more likely to work out allocations of risks, responsibilities, and returns that are mutually acceptable if none is

directors provide enough of the firm's surplus to each residual claimant to keep her in the corporate team (the shareholders receive enough dividends, the employees enough raises, the managers enough perks and prestige, and the creditors enough downside protection), team production can take place and can produce a surplus. Beyond this minimum requirement, who gets exactly what share of that surplus will be determined by which groups best capture the board's attention, which groups argue most persuasively, and, perhaps, by what the directors had for breakfast the morning of the board meeting.

As a solution to the contracting problems associated with team production, the mediating board is obviously messy. It does not, for example, provide directors with a simple goal and an easily observed measure of success (for example, "raise the stock price"). Rather, the mediating hierarchy model recommends that directors try to maximize the economic value of all the firm's assets—a difficult thing to gauge when some of these assets take the form of residual claims on job security, enhanced prestige, or safer credit. In addition, a mediating board is not the only possible solution to team production contracting. For example, in smaller ventures where the participants tend to know each other, interpersonal trust may act as an effective brake on shirking and rent-seeking. Similarly, team production can be encouraged by arranging it so that the managers of the company are also the shareholders, as commonly occurs in closely held firms. We believe, however, that the fact that the mediating board is so widely used in public firms is strong evidence that it has proved a useful "second best" solution in many business situations, especially when human capital and financial capital must come from different sources and when production requires inputs from hundreds if not thousands of individuals who are unknown to each other.

The observation that the mediating board solution necessarily grants directors a wide range of discretion in how to use corporate assets, and that an outside observer may have difficulty in determining how well they do this,⁹⁵ does, however, raise an important question. What makes directors do their job well? What ensures that directors will actually mediate among corporate participants rather than capitulate to one constituency or another, or worse, abscond with corporate assets themselves?

allowed to retain the power that direct "ownership" of and control over the corporation's assets and resulting profits would give them. Thus, by placing ultimate decision-making authority over corporate assets in directors' hands (rather than, say, the hands of managers or large-block shareholders), corporate law facilitates team production.

95. See *supra* text and note 35 (discussing the problem of verifiability in team production).

In this section we have already suggested some answers to this inquiry.⁹⁶ For example, it is clearly important to prevent directors from using the firm's assets to line their own pockets, and the duty of loyalty addresses this problem. Beyond this basic limit, however, the nature of team production makes it almost impossible to develop a legally enforceable substantive standard for the mediating board. The mediating hierarchy model suggests that directors must be accountable to all the firm's residual claimants. Moreover, directors are accountable for maximizing the total value of the residual claimants' interests in the firm. But because the inputs and outputs of team production are to some extent unverifiable—meaning they cannot be readily identified and measured by an outside party such as a court—there is no way to set a substantive judicial standard for gauging how good a job the board is doing.

Instead, the best the law can do is to set procedural standards that discourage director haste and ignorance that would put all the firm's residual claimants at risk.⁹⁷ Disclosure rules, such as those imposed on the boards of public firms under the Securities Exchange Act of 1934,⁹⁸ may also play a useful role. Accurate, audited disclosure is valuable to all the firm's residual claimants, as it not only helps to police against director loyalty violations but also helps each group of corporate participants to gauge whether they are receiving a fair share of the firm's surplus. Is the firm making record profits? Perhaps the union ought to press for a wage increase. Are earnings down? Perhaps the shareholders ought to present the directors with a proposal to limit executive compensation. In fact, under the mediating hierarchy model, strong arguments can be made that we ought to expand our existing disclosure scheme to require firms to accumulate and disclose information relevant to corporate participant's nonfinancial claims, such as information about employee turnover or job satisfaction survey results.⁹⁹

But while setting procedural requirements for directors can contribute to board accountability, procedural requirements alone are not enough. If directors are rationally selfish actors concerned only with their own welfare, imposing procedural standards may only cause them to jump mindlessly through the appropriate procedural hoops, rather than motivating them to

96. See *supra* text and notes 62-66 (discussing the duty of loyalty).

97. See *infra* text accompanying note 115.

98. See 15 U.S.C. §§ 77a-78kk (2000).

99. A recently published report of a special Brookings Institution task force proposes that corporate disclosure rules should be expanded to include many nonfinancial performance measures. See Blair & Wallman, *supra* note 30. See also Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999).

actually do a good job. So we turn next to the question of what else might promote director accountability.

VI. DIRECTOR ACCOUNTABILITY AND THE ROLE OF INTRINSIC TRUSTWORTHINESS

One of the most often repeated arguments raised in favor of shareholder primacy is that if directors and managers are not held accountable to a single constituency, and their performance is not judged by a single, verifiable, and objective metric, they will be accountable for nothing and to no one. Too much discretion, it is argued, leads at best to sloppy management. At worst, it leads to self-serving “empire building,” corporate waste, or even misappropriation of corporate resources.¹⁰⁰

As noted earlier, even while directors enjoy enormous legal discretion in how they choose to manage and allocate corporate resources, as a practical matter this discretion is limited somewhat by economic pressures, such as the cost of capital, the availability of skilled workers, and the demand for the firm’s products.¹⁰¹ These sorts of constraints may well have more effect on the day-to-day decisions of most directors than legal constraints do. There is, however, another possible important curb on director behavior. Although often overlooked or discounted in economic analyses of corporate behavior and corporate law, we believe it may be critical to a full understanding of the role corporate directors play. This constraint is directors’ internalized belief that they ought to behave in a careful, loyal, and trustworthy fashion.

Contractarian corporate analysis, like most economic analysis, generally assumes that the best way to model human behavior is to presume that people are rationally selfish actors. Thus shareholders, creditors, managers, and (most relevant for our purposes) directors are assumed to be utterly indifferent to the effects their actions have on others. Were this actually true, however, the public corporation likely would never have evolved as a successful business form. Given the difficulties associated with trying to bridle directors through shareholder voting and/or derivative suits, rational shareholders, creditors, managers, and employees would never give up control over trillions of dollars of financial capital and trillions more in specific human capital and implicit contract claims to nakedly selfish boards. The social institution of a board of directors rests on the implicit assumption that at least some people, to some extent, some of the time, are capable of

100. See, e.g., Hansmann & Kraakman, *supra* note 3, at 439-43. See also Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982).

101. See *supra* text accompanying notes 91-93.

looking out for the interests of others—even when they reap no direct economic benefit from doing so.¹⁰² Indeed, this assumption underlies most fiduciary relationships.¹⁰³

Economists accustomed to employing automatically the *homo economicus* model of human behavior may be uncomfortable with relying on the idea that people sometimes are willing to serve others without direct reward. Yet most people—and certainly most business people—recognize at least intuitively that individuals often can be counted upon to “do the right thing.” This is not to say self-interest is unimportant. To the contrary, in the right circumstances most of us are fully capable of acting in a purely selfish fashion. But under other circumstances, most of us also are capable of kindness, consideration, charity, loyalty, and faithfulness. To use economists’ parlance, people’s behavior sometimes “reveals a preference” for taking account of others’ interests in making decisions.¹⁰⁴

For cynics who doubt this, in a recent joint article we surveyed some of the extensive empirical evidence that psychologists, sociologists, and other social scientists produced on one form of other-regarding revealed preference—trustworthy behavior.¹⁰⁵ This evidence establishes two propositions beyond any reasonable empirical challenge. First, trustworthy behavior occurs. Most people are quite capable of choosing to make some

102. This may be most obvious in the case of a nonprofit board, but for reasons discussed earlier it also is for many for-profit boards as well. See *supra* text accompanying notes 92-95 (discussing director autonomy).

103. See *Meinhard v. Salmon*, 164 N.E. 545, 545-48 (N.Y. 1928) (“Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. . . . [A fiduciary puts] himself in a position in which thought of self [is] to be renounced, however hard the abnegation.”). Fiduciary relationships are premised on some degree of altruism because, while the fiduciary may be paid a fee for her services, that payment usually is not contingent on any objective performance measure. Thus, the fiduciary has little extrinsic motivation to exert effort on the beneficiary’s behalf.

104. It can be argued that altruism driven by internalized punishments, such as guilt, is in a sense consistent with self-interest. This may be true. From an economic perspective, however, if such internal motivations induce altruistic behavior when extrinsic incentives do not support it, the end result is a “revealed preference” for other-regarding behavior.

105. See Blair & Stout, *supra* note 7. In this Article, we define “trustworthiness” as an internalized belief that one should not exploit another’s vulnerability, that, in turn, makes others willing to make themselves vulnerable. The mediating hierarchy model relies on trustworthy behavior by directors, because it predicts that corporate participants will agree to make themselves mutually vulnerable by giving the hierarch control of their firm-specific investments.

Alternative forms of other-regarding behavior may include pure generosity (distinguished from trustworthiness because the recipient does not change her position in reliance upon the expectation of altruism) and vengeance (a willingness to incur a personal cost in order to punish another). See generally Lynn A. Stout, *Other-Regarding Preferences and Social Norms* (2001) (working paper, on file with author).

degree of personal sacrifice to benefit others.¹⁰⁶ Second, this behavior is not quirky or unpredictable. To the contrary, people can be counted upon with some reliability to behave in a trustworthy fashion when the economic and social conditions are favorable.¹⁰⁷

When are the economic and social conditions “favorable”? Social scientists have devoted enormous energy in recent years trying to determine exactly what sorts of factors and variables are likely to elicit fair, honorable, and trustworthy behavior. This effort has generated considerable formal knowledge about what circumstances are likely to trigger altruism and what circumstances trigger selfishness.¹⁰⁸ A full discussion of the determinants of other-regarding behavior lies beyond the scope of our argument, as does a full discussion of how other-regarding behavior relates to corporate law. But some basic lessons can be drawn from the empirical literature that may be of great value in understanding what motivates and influences corporate directors.

A. Determinants of Trustworthy Behavior

Let us focus first on the role played by social variables in eliciting trustworthy behavior. In a wide variety of experiments designed to test people’s willingness to provide benefits to others (or to refrain from imposing costs on them), social scientists have found that the decision to behave in an other-regarding fashion is remarkably sensitive to social context—meaning the subjects’ perceptions of *others’* beliefs, expectations, likely actions, and relationships to themselves. For example, in “social dilemma” games where subjects are asked to choose between a cooperative strategy that maximizes the group’s payoff and a noncooperative strategy that maximizes their personal payoffs, experimenters have found that by manipulating social context they can produce everything from nearly universal cooperation to an almost absolute absence of cooperation—even though a purely selfish subject would always choose noncooperation.¹⁰⁹

Three social variables in particular appear to play powerful roles in determining when people behave selfishly and when they behave more cooperatively. The first variable is instructions from authority. Studies have

106. See Blair & Stout, *supra* note 7, at 1764-66.

107. *Id.* at 1768-75

108. *Id.*

109. See Blair & Stout, *supra* note 7, at 1768. This implies that most people behave as if they have two revealed preference functions. One is competitive and self-regarding; the other is cooperative and other-regarding. Social context largely determines when the cooperative preference function dominates. *Id.* at 1761-62.

found that subjects in experimental games behave far more altruistically toward their fellow players when the experimenter tells them, or even hints to them, that they should do this, even though such instructions do not change the players' economic incentives.¹¹⁰ Second, other-regarding behavior depends on perceptions of group identity. Subjects are more likely to cooperate with other players when they perceive them as belonging to a common "in-group" than when they perceive the other players as belonging to an "out-group."¹¹¹ Finally, altruism appears to be influenced by herd behavior. When a subject believes others are behaving altruistically, she is more likely to behave altruistically herself.¹¹²

While such social factors play highly influential roles in determining the incidence of trustworthy behavior, economic factors are not unimportant. Studies find that, when the social conditions are right, experimental subjects will incur a personal sacrifice to behave altruistically. But as the personal cost associated with benefitting others rises, the degree of altruism observed begins to decline.¹¹³ In other words, the supply of trustworthy behavior as a function of the cost of behaving trustworthily may be "downward sloping." As the personal cost associated with trustworthiness rises, the degree of trustworthy behavior observed declines.¹¹⁴

B. Encouraging Director Trustworthiness

These findings offer a variety of insights into the problem of how to motivate corporate directors to better serve the interests of the coalition of corporate participants that makes up the firm. Perhaps most obviously, the findings underscore the importance of the director's duty of loyalty. An enforceable duty of loyalty rule can punish a director who employs her corporate power for her own benefit (or, at least, for her own pecuniary benefit). As a result, the duty of loyalty encourages altruistic behavior by reducing its relative personal cost. In effect, a director might say to herself,

110. *See id.* at 1769-70.

111. *See id.* at 1770-72.

112. *See id.* at 1772-73.

113. *See id.* at 1773-75. For example, one regression analysis found that doubling the reward from defecting in a social dilemma decreased cooperation rates by as much as sixteen percent. *Id.* at 1774.

114. This raises the question: If trustworthiness only appears when it is not too costly, how can it be a source of significant social gains? One answer to this question is that trustworthy acts requiring only a modest sacrifice on the part of the trusted actor can produce much larger gains for the trusting actor. In the case of corporate directors, such situations may arise with some frequency. For example, a marginal increase in the degree of care exercised by a corporate board will greatly benefit the firm when it prevents the loss or destruction of a valuable corporate asset. *See id.* at 1774-75 (discussing other answers to this question).

“Since I can’t use my position to make myself better off, I might as well use it to make others better off.” In contrast, a toothless duty of loyalty discourages director trustworthiness by offering directors the tempting opportunity to use their control over corporate assets to increase their own wealth at the expense of the firm.

Imposing purely procedural requirements on directors similarly can encourage good corporate governance. The argument goes as follows: under the business judgment rule, courts refuse to second-guess the substantive wisdom of directors’ decisions. Instead, the rule merely requires directors to make their decisions in an informed and deliberate manner. But once directors have gone to the trouble of informing themselves, taking the next step—actually thinking about what they have learned—does not require much additional effort. Thus procedural rules also can encourage greater director care by reducing the marginal personal cost of taking care.¹¹⁵

The empirical evidence suggests that directors can be further encouraged to behave trustworthily by employing a variety of “soft” social variables.¹¹⁶ One of the most obvious may be the dicta of judicial opinions. As noted earlier, experimental subjects are far more likely to behave altruistically when they are instructed to do so by the experimenter.¹¹⁷ In the context of corporate law, courts may enjoy a parallel position of influence and authority. If so, judicial pronouncements that directors ought to behave in a trustworthy (careful and loyal) fashion probably influence behavior even in the absence of legal sanctions.¹¹⁸ Similarly, directors who perceive themselves as sharing in-group status with the firm’s employees, managers, and shareholders, will be more likely to behave trustworthily with respect to these groups than directors who do not. Finally, directors who believe that other directors are behaving trustworthily will be more likely to do the same.

In other words, there are a wide variety of social signals and cues available to encourage directors of public corporations to be “accountable” to

115. See Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Van Gorkom and the Business Judgment Rule*, 95 NW. L. REV. (forthcoming 2001).

116. See *supra* text accompanying notes 110-12.

117. See *supra* note 110 and accompanying text.

118. A related argument has been offered by Edward Rock, who argues that judicial opinions on the duty of care may influence director behavior not primarily through the threat of legal sanction, but by providing a “sermon” on what sort of behavior is normatively desirable. See generally Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997). While Rock acknowledges the possibility that directors may internalize such “norms”, however, his analysis rests primarily on his claim that judicial norms are enforced through nonlegal, external punishments such as social disapproval and lost opportunities to sit on other boards. For a variety of reasons, we think internalized beliefs may be at least as important as such external factors. See Blair & Stout, *supra* note 7, at 1794-96 (discussing reasons).

the firm, even when the available external rewards and punishments seem to give little incentive for accountability. This behavioral reality gives hope to those who bemoan directors' apparent lack of accountability by suggesting why, even in the absence of observable carrots and sticks, directors will often try to do the right thing in the boardroom. Further, it suggests the value that can be gained from modifying the *homo economicus* approach to the question of director accountability to take account of intrinsic trustworthiness and other actualities of human nature.¹¹⁹

C. On the Dangers of Shareholder Primacy Rhetoric

Finally, our analysis also hints at the potential dangers of overemphasizing the principle-agent model and the rhetoric of shareholder primacy. In recent years, the claim that corporate executives need stronger motivations to raise share price has been used to justify astoundingly large compensation packages for corporate executives in the form of incentive stock options.¹²⁰ More recently, academics and commentators have begun to argue that directors, too, should be paid in stock.¹²¹ But the observation that trustworthy behavior only tends to flourish in circumstances where the cost of such behavior is low presents a challenge to these trends.

Traditionally, corporate directors received a fixed annual fee, and often a relatively modest one at that, for their services.¹²² If this system of compensation did not exactly spur them to employ maximum effort as mediating hierarchs, it gave them no incentive to do otherwise. Director compensation systems that tie director pay to stock price performance, however, may introduce conflicts of interest that make it much more difficult for directors credibly to play a mediating role.

The rise of the shareholder primacy model may also undermine directors' ability to serve as mediating hierarchs in a second fashion—by changing the social context in which the board operates. We explored above how judicial dicta may be an important determinant of director behavior.¹²³ When courts

119. See, e.g., Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 787 (2001).

120. See Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990. See also G. Bennett Stewart III, *Remaking the Public Corporation From Within*, HARV. BUS. REV., July-Aug. 1990.

121. See, e.g., Charles M. Elson, *Director Compensation and the Management—Capital Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1996). See also Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649 (1995).

122. See CLARK, *supra* note 58, at 108-09 (noting that directors typically receive a flat fee unrelated to their performance).

123. See *supra* note 118 and accompanying text.

tell directors to serve the firm, and make it clear that “the firm” is not synonymous with “the shareholders,” directors will be more likely to take account of other corporate constituencies in making their decisions. Conversely, when courts tell directors to serve only the shareholders (or, more realistically, when corporate attorneys trained by law professors who favor the principal-agent model tell directors they should only serve the shareholders) directors are more likely to feel they ought to do this. Similarly, when corporate scholars and the business press repeatedly assert that shareholders “own” the firm and that the directors are merely the shareholders’ “agents”, directors are likely to define the corporate in-group to whom they owe loyalty as including only the shareholders. Directors are also likely to suspect that other directors at other companies are single-mindedly pursuing high share prices, and therefore they ought to do the same.

The bottom line is that scholars, lawmakers, and businesspeople who are willing to adopt a more nuanced model of human behavior that incorporates the empirical phenomenon of intrinsic trustworthiness may be able to identify a variety of mechanisms for encouraging director accountability that ultimately could prove more effective than a crude “carrot-and-stick” approach emphasizing external incentives. In other words, there may be many more useful answers to the question of how directors can be made accountable than traditional contractarian analysis recognizes. This hopeful possibility only heightens the importance of finding the correct answers to the antecedent questions: *to whom* should directors be accountable, and *for what*?

VII. CONCLUSION

Over the past few decades, a consensus emerged among most corporate scholars that the directors of a public corporation ought to run the firm with an eye to one goal only—maximizing the economic value of the stockholders’ shares within the confines of the law. Yet even as this shareholder primacy view has begun to gain traction outside of academia, more recent work in economics has begun to undermine it. The lessons of options theory and the reality of firm-specific investment counsel against assuming that directors of public firms ought to behave as shareholders’ agents. To the contrary, directors of public firms not only enjoy, but should enjoy, a remarkable degree of freedom from the commands of shareholders or, indeed, any other corporate constituency. This director autonomy amplifies agency cost problems by giving directors greater leeway to indulge in a variety of self-serving behaviors (most obviously, shirking). Because it also allows directors to act as mediating hierarchs, however, it may provide a

second best solution to the contracting difficulties associated with team production.

Team production analysis thus suggests that one of the most important tasks that directors of public firms perform is a balancing act in which they pay attention and respond to the competing claims of a variety of important corporate constituencies. These constituencies include not only shareholders, but also creditors, managers, rank-and-file employees, and even the local community—essentially any group that bears significant risks or makes significant firm-specific investments. In juggling the competing demands and needs of these groups, directors are driven by one economic imperative: the need to keep the corporate team together and keep it productive. Provided they can do this, however, directors will retain and should retain the ultimate authority to decide who gets what share of the resulting corporate surplus.

By emphasizing the importance of director autonomy, the team production model of the mediating board in many ways does a better job than the shareholder primacy model of explaining the way corporate law actually works. It is also in harmony with the way many directors view their own jobs. Although many corporate directors have come to accept shareholder primacy as their ultimate goal, many others view themselves as “brokers” or “referees” who must weigh the interests of the shareholders against those of other legitimate corporate constituencies, including employees, creditors, and customers.¹²⁴

Of course, in many circumstances, arguably most, it will be in the shareholders’ interest for the board to consider the needs of other constituencies in calculating what is best for the firm as a going concern. If a company expects to be a “repeat player” in a labor or credit market, it is not in the shareholders’ long-run interest for the firm to sully its reputation by ruthlessly taking advantage of creditors or employees. Thus shareholder primacy advocates might be tempted to claim that other corporate constituencies will automatically be protected in a shareholder primacy regime. Unfortunately, under a rule of strict shareholder primacy that bids the board of every firm to favor the interests of shareholders at every turn, this is not the case. While team production analysis suggests that shareholders as a class are better off if they “tie their own hands” by ceding control of the firm

124. See, e.g., Robert H. Campbell, *Directors: ‘The Brokers of Balance,’* DIRECTORS & BOARDS, Summer 1996, at 45-47 (arguing that the “overriding challenge” facing directors is to strike “an appropriate balance between the seemingly conflicting needs of the stakeholders,” and describing directors as “brokers” and “referees”). See also J. Keith Loudon, *A Position Description for the Board,* DIRECTORS & BOARDS, Spring 1993, at 23.

to a mediating board,¹²⁵ particular groups of shareholders in particular firms can still profit from opportunistic behavior. For example, investors who target specific companies and buy enough shares to elect a new board may, in certain situations, be able to renege on implicit understandings with other corporate participants, or to undertake highly risky strategies that benefit themselves at other participants' expense.¹²⁶ Thus policies that serve shareholders as a class do not always maximize the value of every investor's shares. A simplistic allegiance to shareholder primacy that denies such a possibility, and insists that shareholders should have the right and the power to do whatever they want with "their" company, ultimately makes shareholders—as well as other corporate constituents—worse off.

Careful analysis consequently highlights the danger associated with a simplistic rhetoric of shareholder primacy that treats the interests of "the shareholders" as synonymous with the interests of "the firm." Nine times out of ten, corporate policies that serve the shareholders' interest may serve the interests of other corporate constituents as well. It is important, however, for corporate directors to be able to recognize and respond to situations where this is not the case. Of course, this subtlety comes with a cost. The mediating board model replaces an easily measurable goal of good corporate governance (raise the price of the firm's shares) with one that is far more complex and difficult for outsiders to observe (maximize the value of the firm as a whole). In the process, it emphasizes the importance of ensuring that mediating directors operate in an environment where both the economic and the social variables encourage them to behave trustworthily.

125. This benefit is recognized by sophisticated financial investors who often appreciate the need to accommodate and protect the interests of other corporate constituencies in order to protect their own, especially in industries where the contributions of nonfinancial participants play a key role. In Britain, for example, a group of eight British institutional investors, together with PricewaterhouseCoopers and BP Amoco, agreed to call on U.K. companies to "manage effectively relationships with its employees, suppliers and customers, to behave ethically and to have regard for the environment and society as a whole." *Social Graces*, GLOBAL PROXY WATCH, Jan. 26, 2001. Hermes Investment Management revised its corporate governance policies to reflect this new approach and asked companies to both disclose their policies in these areas annually and to have a credible system in place for verifying the accuracy of these disclosures. *Id.* Hermes Investment Management has also asked that compensation committees on boards "consider the effect on the company's performance of social, environmental and ethical matters" as part of its remuneration decisions. *Id.* The other institutions in the group are expected to adopt the language too. *Id.* For institutional investors who are widely diversified, these sorts of corporate governance policies clearly make sense as a means of encouraging nonshareholder groups to make specific investments in team production.

126. For example, one study suggested that the apparent economic gains enjoyed by shareholders in Carl Icahn's takeover of Trans World Airlines (TWA) all came from the lost wages of the airline's employees. See Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33-56 (Alan J. Auerbach ed., 1988).

The result may be a messy, second best solution to the contracting problems associated with economic production in public corporations. It is a solution, however, that has stood the test of time. The “separation of ownership and control” remains a basic characteristic of the U.S. public corporation, although Professors Berle and Means first complained of it in the 1930s.¹²⁷ Nevertheless, the public corporation survives and thrives. In light of this reality, as well as the lessons of the contemporary economic and other social sciences literature, we should hesitate before concluding that the mediating board of directors is a broken institution that needs fixing.

127. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

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