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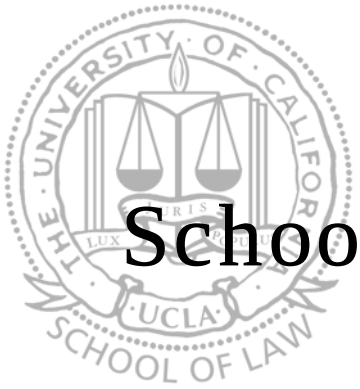
Director Primacy:
The Means and Ends of Corporate Governance

Stephen M. Bainbridge

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The Means and Ends of Corporate Governance

Stephen M. Bainbridge*

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* Professor, UCLA School of Law. Portions of this Article are based on Chapter 9 of my Foundation Press text, CORPORATION LAW AND ECONOMICS (forthcoming 2002). I am grateful to Margaret Blair, Bill Klein, and Lynn Stout for their constructive criticism of an earlier draft. I also thank the participants in the Georgetown-Sloan Project on Business Institutions' Conference on Corporations as Producers and Distributors of Rents, where an earlier draft of this paper was presented.

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I. INTRODUCTION

Since Ronald Coase's justly famous article *The Nature of the Firm* appeared over six decades ago,[1] both economists and legal scholars have devoted considerable attention to the theory of the firm. Although the resulting models can be classified in various ways, and some defy classification, two basic systems of classification capture most of the competing theories. (See Figure 1.) Along one axis (call it the "means axis"), theories of the firm are plotted according to whether they emphasize managerial or shareholder primacy. Theories at the shareholder primacy end of the spectrum traditionally claimed that shareholders own the corporation.[2] Accordingly, directors and officers are mere stewards of the shareholders' interests. A more recent variant, which is one of Coase's many progeny, argues that shareholders are merely one of many factors of production bound together in a complex web of explicit and implicit contracts.[3] Influenced by agency cost economics, proponents of this variant continue to treat directors and officers as agents of the shareholders, with fiduciary obligations to maximize shareholder wealth.[4] Shareholders therefore retain a privileged position among

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[1] R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA (N.S.) 386 (1937).

[2] *See infra* notes 64-65 and accompanying text.

[3] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 12 (1991) (noting the "many actors" who collectively participate in the firm).

[4] *See, e.g., id.* at 91 (describing corporate managers as "agents of the equity investors" who "pledge their careful and honest services"). In Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del.Ch. 1988), former Delaware Chancellor William Allen opined: "The theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters." *Id*. at 663. Director primacy squarely rejects this claim. *See infra* note 15 and accompanying text.

the corporation's various constituencies, enjoying a contract with the firm having ownership-like features, including the right to vote and the fiduciary obligations of directors and officers.

At the other end of the means axis lies managerialism. Competing managerialist models long dominated corporate law scholarship and remain influential in some other disciplines, but they no longer have much traction in the legal academy.[5] Managerialism conceives the corporation as a bureaucratic hierarchy dominated by professional managers.[6] Directors are figureheads, while shareholders are nonentities.[7] Managers are thus autonomous actors free to pursue whatever interests they choose (or society directs).[8]

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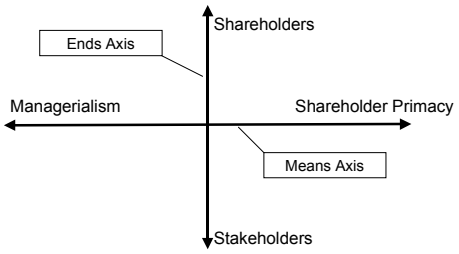
[5] *See generally* William W. Bratton, *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989) (discussing managerialist theories of the firm); Allen Kaufman & Lawrence Zacharias, *From Trust to Contract: The Legal Language of Managerial Ideology*, 1920-1980, 66 BUS. HIST. REV. 523 (1992) (same).

[6] The classic managerialist account remains ALFRED D. CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977).

[7] *See, e.g.,* PETER F. DRUCKER, CONCEPT OF THE CORPORATION 92 (rev ed. 1972) (describing outside directors as figureheads). Instructively, the index to Drucker's classic analysis of General Motors does not contain an entry for shareholders. *See id.* at 318-19 (index).

[8] *See infra* notes 53-56 and accompanying text (discussing the managerialist assumptions made by Berle and Dodd).

Figure 1
Plotting Models of the Firm



Along the other axis (call it the "ends axis"), models can be plotted according to the interests the corporation is said to serve. At one end of the spectrum are those who contend corporations should be run so as to maximize shareholder wealth. At the other end are stakeholderists, who argue that directors and managers should consider the interests of all corporate constituencies in making corporate decisions.[9] This axis reflects the division in corporate law scholarship along public-private lines.[10] Proponents of shareholder wealth maximization typically treat corporate governance as a species of private law, such that the

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[9] *See* Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 877 (1997) (discussing stakeholderism). As applied to corporation law and policy, the term "stakeholders" reportedly originated in a 1963 Stanford Research Institute memorandum as a descriptive term for "those groups without whose support the organization would cease to exist." R. Edward Freeman & David L. Reed, *Stockholders and Stakeholders: A New Perspective on Corporate Governance*, 25 CAL. MGMT. REV. 88, 89 (1983). I have a slight preference for the term "nonshareholder constituencies," which captures the idea of shareholders as having distinct interests from those of other stakeholders, but use the terms interchangeably.

[10] *See* William W. Bratton, *Berle and Means Reconsidered at the Century's End*, 26 J. CORP. L. 737, 760-61 (2001) (noting public/private divide); Lawrence E. Mitchell, *Private Law, Public Interest? The ALI Principles of Corporate Governance*, 61 GEO. WASH. L. REV. 871, 876 (1993) (noting debate as to "whether the modern corporation is essentially a matter of public or private concern").

separation of ownership and control does not in and of itself justify state intervention in corporate governance. In contrast, stakeholderists commonly treat corporate governance as a species of public law, such that the separation of ownership and control becomes principally a justification for regulating corporate governance so as to achieve social goals unrelated to corporate profitability.

At bottom, all of these models are ways of thinking about the means and ends of corporate governance. They strive to answer two basic sets of questions: (1) As to the means of corporate governance, who decides? In other words, when push comes to shove, who ultimately is in control? (2) As to the ends of corporate governance, whose interests prevail? When the ultimate decisionmaker is presented with a zero sum game, in which it must prefer the interests of one constituency class over those of all others, which constituency wins?

Any model that commands the loyalty of one or more generations of scholars doubtless has more than grain of truth. Yet, none of the standard models is fully satisfactory. There remains room for a new competitor; namely, director primacy.

Shareholder primacy models assume that shareholders both control the corporation, at least in some ultimate fashion, and are the appropriate beneficiaries of director fiduciary duties.[11] Managerialist models assume that top management controls the corporation, but differ as to the interests managers should pursue.[12] Stakeholderist models rarely focus on control issues, instead emphasizing that shareholders should not be the sole beneficiaries of director and officer fiduciary duties.

Director primacy splits the baby rather differently. As to the means axis, director primacy asserts that neither end of the spectrum gets it right. Neither shareholders nor managers control corporations—boards of directors do. As to the ends axis, director primacy claims that shareholders are the appropriate beneficiary of director fiduciary duties. Hence, director accountability for maximizing shareholder wealth remains an important component of director primacy.[13]

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[11] *See infra* Part II.E (discussing shareholder primacy models).

[12] *See, e.g., infra* notes 55-56 and accompanying text (describing the Berle-Dodd debate).

[13] A fully specified shareholder wealth maximization regime obviously requires a metric by which shareholder wealth is measured. Developing the content of such a

This Article is one of the first in a planned series intended to work out the implications of director primacy across a range of core corporate law doctrines. Subsequent articles will address the director primacy model's application to such basic issues as shareholder voting rights and the powers of the board with respect to corporate takeovers. Because this Article is intended to broadly lay out the basic concepts of director primacy, the focus here is less on doctrine than on first principles.

The director primacy model proposed herein is grounded in the prevailing law and economics conception of the firm; namely, the so-called nexus of contracts model. Accordingly, Part II begins with a brief summary of the standard model. As we shall see, the standard contractarian account treats the firm as the nexus of contracts.[14] In contrast, director primacy treats the corporation as a vehicle by which the board of directors hires various factors of production. The board of directors thus is not a mere agent of the shareholders, but rather is a *sui generis* body—a sort of Platonic guardian[15]—serving as the nexus for the various contracts making up the corporation.

Part II then distinguishes director primacy from both managerialism and shareholder primacy. Law and economics-oriented corporate law scholars typically acknowledge the board's considerable discretionary powers, but treat those powers mainly as a source of agency costs to be constrained by market and/or legal forces.[16] In doing so, however, they allow the tail to wag the dog. To be sure, deterrence and punishment of misconduct by the board is necessary, but accountability standing alone is an inadequate normative account of corporate law. Fiat exists—and fiat matters. A fully specified account of corporate law therefore must incorporate the value of authority—i.e., the need to develop a set

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metric, however, is beyond the scope of this article. For criticism of judicial metrics entailing notions of "intrinsic value," see MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 245-47 (1995) (criticizing the Delaware supreme court's decision in Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)).

[14] *See infra* note 23 and accompanying text.

[15] *See* PLATO, THE REPUBLIC 289-90 (Benjamin Jowett trans. 1991), in which Socrates describes the education of philosopher-kings who rule "for the public good, not as though they were performing some heroic action, but simply as a matter of duty." *Id.*

[16] *See infra* notes 69-71 and accompanying text (describing that position).

of rules and procedures that provides the most efficient decisionmaking system.[17]

Part III turns to the ends axis of Figure 1. In the nexus of contracts model, there is nothing unique about the shareholder-corporate relationship. Shareholders are simply one of the inputs bound together by a web of voluntary agreements whose nexus the law treats as a firm. Contractarianism thus allows us to think about the shareholder-director relationship in radically new ways. Although shareholder primacy and the shareholder wealth maximization norm are often conflated, one can have the latter without necessarily endorsing the former. Hence, Part III argues that the director primacy model can be reconciled with a contractual obligation on the board's part to maximize the value of the shareholders' residual claim.

Given the voluminous nature of the corporate social responsibility debate, one inevitably must be highly selective in choosing an analytical foil. Among the most interesting recent contributions to the literature is the iconoclastic work of Margaret M. Blair and Lynn A. Stout. In a provocative series of recent articles, Blair and Stout have set out a so-called "team production" model somewhat resembling director primacy, but also differing from director primacy in key respects.[18] Along the means axis of Figure 1, Blair and Stout's model takes a director primacy-like view of corporate governance. Blair and Stout argue, for example, that directors "are not subject to direct control or supervision by *anyone*, including the firm's shareholders."[19]A critical difference between our respective models, however, is suggested by Blair and Stout's argument "that hierarchs work for team members (including employees) who 'hire' them to control shirking and rent-seeking among team members."[20] Director primacy claims this is exactly backwards—directors hire factors of production, not vice-versa. Hence, as Part IV explains, director primacy rejects Blair and Stout's argument that directors serve as mediating hierarchs.

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[17] *See generally* Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461 (1992) (exploring the differences between so-called Authority and Responsibility models of corporate governance).

[18] *See, e.g.,* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. CORP. L. 743 (1999).

[19] Blair & Stout, *supra* note 18, at 290 (emphasis in original).

[20] *Id*. at 280 (emphasis removed).

II. THE MEANS AXIS: THE BOARD AS NEXUS OF CONTRACTS

In order for an organization to survive, its governance system must allocate authority to make adaptive decisions and define the norms that should guide the chosen decisionmakers.[21] For U.S. corporations the latter is provided by the shareholder wealth maximization norm.[22] The former is provided by a branching hierarchy surmounted by a board of directors with the power to effect adaptive change through fiat.

A. The Contractarian Foundations of Director Primacy

The now standard nexus of contracts model treats the corporation as a nexus of contracts among the various factors of production.[23] To be sure, one must avoid reifying the firm.[24] Yet, some deference should be shown the corporation's status as a legal person. Corporate constituents contract not with each other, but

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[21] Dooley, *supra* note 17, at 466.

[22] *See infra* notes 110-113 and accompanying text.

[23] *See, e.g.*, HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 18 (1996) (describing the firm as "a nexus of contracts," by which he means that the "firm is in essence the common signatory of a group of contracts" among various factors of production). Contractarians thus model the firm not as an entity, but as an aggregate of various inputs acting together to produce goods or services. Employees provide labor. Creditors provide debt capital. Shareholders initially provide equity capital and subsequently bear the risk of losses and monitor the performance of management. Management monitors the performance of employees and coordinates the activities of all the firm's inputs. The board supervises management and sets overall policy. *See generally* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989); Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. Corp. L. 301, 318-28 (1993); *see also* William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993) (former Delaware Chancellor opining that the nexus of contracts model of the firm is now the "dominant legal academic view").

[24] *See* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 108-09 (7th ed. 2000) (critiquing reification of the corporation); *see also* G. Mitu Gulati, William A. Klein, & Eric M. Zolt, *Connected Contracts*, 47 UCLA L. REV. 887, 947 (2000) (arguing that "there is no primacy, no core, no hierarchy, no prominent participant, no firm, no fiduciary duty").

with the corporation. A bond indenture thus is a contract between the corporation and its creditors,[25] an employment agreement is a contract between the corporation and its workers,[26] and a collective bargaining agreement is a contract between the corporation and the union representing its workers.[27] If the contract is breached on the corporate side, it will be the entity that is sued in most cases, rather than the individuals who decided not to perform. If the entity loses, damages typically will be paid out of its assets and earnings rather than out of those individuals' pockets. This entity-based understanding of the firm is necessitated by the absence of mechanisms for corporate constituents to communicate—let alone contract—with one another. The various constituencies thus must be (and are) linked to the nexus and not each other.[28] (See Figure 2.)

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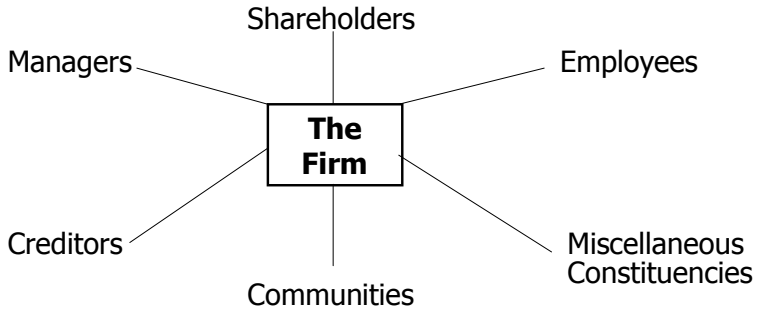
[25] *See, e.g.*, Lorenz v. CSX Corp., 1 F.3d 1406, 1417 (3rd Cir. 1993) (stating "It is well-established that a corporation does not have a fiduciary relationship with its debt security holders, as with its shareholders. The relationship between a corporation and its debentureholders is contractual in nature."); Simons v. Cogan, 549 A.2d 300, 303-04 (Del. 1988) (holding that "a convertible debenture represents a contractual entitlement to the repayment of a debt").

[26] *See, e.g.*, Berman v. Physical Med. Assocs. 225 F.3d 429, 12 (4th Cir. 2000) (holding that, "as to Berman's claims under the employment agreement and severance benefit agreement, only the corporation owed Berman a contractual duty").

[27] *See* John Wiley & Sons, Inc. v. Livingston, 376 U.S. 543, 546 (1964) (asking "whether the arbitration provisions of the collective bargaining agreement survived the Wiley-Interscience merger, so as to be operative against" successor corporation).

[28] *See* Jean-Jacques Laffont & David Martimort, *The Firm as a Multicontract Organization*, 6 J. ECON. & MGMT. STRATEGY 201, 207 (1997). *See also* Melvin A. Eisenberg, *The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 830 (1999) (stating that "a particular corporation consists of all and only those reciprocal arrangements that are linked not just to each other, but to *something*"; emphasis in original). Eisenberg contends that the nexus of contracts model lacks intellectual coherence. *Id.* at 830-31. The director primacy variant of contractarian theory, however, answers his critique. Eisenberg asks, for example, "how we know that an individual is the manager or common agent of a firm unless we have a prior conception of the firm?" *Id.* at 831. We know because the director primacy conception of the firm starts with the board and then assumes that the board hires all other inputs of production. Yet, Eisenberg may object, that many contracts are executed by "nonmanagerial employees." *Id*. True, but when one agent hires another, the latter becomes a sub-agent of the original principal. Just so, nonmanagerial employees are

Figure 2
The standard contractarian account
The firm *is* a nexus



B. The Virtues of Fiat

In one sense, the corporation *is* a nexus of contracts. In a more important sense, however, the corporation *has* a nexus. Despite their contractual nature, public corporations are not participatory democracies, but hierarchies in which decisions are made on a more-or-less authoritarian basis.[29] Why? What survival advantages does a large corporation gain from bureaucratic hierarchy?

An answer is suggested by Ronald Coase's fundamental insight that if a corporate employee moves from department Y to department X he does so not because of change in relative prices, but because he is ordered to do so.[30] In other

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ultimately linked contractually (at least in the economic sense of the word) to the corporate nexus—i.e., the board of directors.

[29] CHANDLER, *supra* note 6, at 8 (stating that corporate hierarchies have proven to possess "a permanence beyond that of any individual or group of individuals who worked in them.").

[30] Coase, *supra* note 1, at 387

words, markets allocate resources via the price mechanism but firms allocate resources via authoritative direction.[31] Accordingly, organizing economic activity within a firm is more efficient than doing so across markets when the costs of bargaining are higher than the costs associated with command-and-control.

There are several ways in which organizing economic activity via fiat can reduce transaction costs vis-à-vis markets. Where production requires some form of team effort, for example, bringing economic activity within the boundaries of firm can reduce search and related bargaining costs.[32] Bringing together employees, creditors, equity investors, and other necessary factors of production requires on-going interactions too complex to be handled through a price mechanism.[33] The firm solves that problem by creating a centralized contracting party—some team member is charged with seeking out the necessary inputs and bringing them together for productive labor.[34]

Fiat can also lower costs associated with uncertainty, opportunism, and complexity.[35] Given the limits on cognitive competence implied by bounded

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[31] Drawing a distinction between across-market transactions and intra-firm transactions serves a useful pedagogic purpose, but is not a wholly accurate description of the real world, in which there is a wide array of choices falling between purely contractual relationships and the classical economic firm. *See* William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1523 (1982).

[32] The canonical example is Adam Smith's study of pin manufacturing. Smith observed that pin making requires eighteen distinct operations. A substantial synergistic effect resulted when a team was organized in which each operation was conducted by a separate individual: the team was able to produce thousands of pins a day, while an individual alone might produce one pin a day at best. ADAM SMITH, THE WEALTH OF NATIONS 4-5 (Modern Library ed. 1937). In theory, production teams of this sort can be organized through some form of decentralized price mechanism. *See* Sherwin Rosen, *Transaction Costs and Internal Labor Markets*, in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 75, 78 (Oliver E. Williamson & Sidney G. Winter eds. 1991) (describing historical examples of quasi-assembly line production processes involving independent craftsmen transacting across a small local market).

[33] Rosen, *supra* note 32, at 84-85.

[34] Coase, supra note 1, at 392.

[35] Uncertainty arises in business relationships because it is difficult to predict the future conditions the parties will face. Opportunism arises because parties to a contract are inevitably tempted to pursue their own self-interest at the expense of the collective

rationality,[36] incomplete contracts are the inevitable result of the uncertainty and complexity inherent in on-going business relationships.[37] In turn, incomplete contracts leave greater room for opportunistic behavior. According to the Coasean theory of the firm, firms arise when it is possible to lower these costs by delegating to a team member the power to direct how the various inputs will be utilized by the firm. In other words, one team member is empowered to unilaterally rewrite terms of the contract between the firm and its various constituents.[38]

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good, which in market transactions leads to contract breaches requiring resort to costly enforcement mechanisms. Complexity arises when the parties attempt to contractually specify how they will respond to a given situation. As the relationship's term lengthens, it necessarily becomes more difficult to foresee the needs and threats of the future, which in turn presents an ever-growing myriad of contingencies to be dealt with. *See generally* Dooley, *supra* note 17, at 471-512 (explaining how these costs relate to the theory of the firm). The three factors are not wholly independent. Uncertainty can result from opportunistic behavior, for example, where there is strategic nondisclosure or deliberate distortion of information. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 57 (1985).

[36] The term bounded rationality was coined by Herbert Simon. *See* Herbert A. Simon, *Rational Choice and the Structure of the Environment*, in MODELS OF MAN 261, 271 (1957). According to the theory of bounded rationality, economic actors seek to maximize their expected utility, but the limitations of human cognition often result in decisions that fail to maximize utility. Decisionmakers inherently have limited memories, computational skills, and other mental tools, which in turn limit their ability to gather and process information. *See generally* Roy Radner, *Bounded Rationality, Indeterminacy, and the Theory of the Firm*, 106 ECON. J. 1360, 1362-68 (1996) (providing an especially detailed taxonomy of the various forms bounded rationality takes, with special emphasis on the theory's relevance with respect to the organization for firms).

[37] *See* WILLIAMSON, *supra* note 35, at 30-32, 45-46 (arguing that complete contracts are at best costly and may prove impossible under the specified conditions); *see also* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES 23 (1975) (arguing that, under conditions of uncertainty and complexity, it becomes "very costly, perhaps impossible, to describe the complete decision tree").

[38] Oliver Williamson's transaction costs economics offers a more robust account of the costs associated with bargaining that can be reduced through hierarchical ordering of production within a firm, among which are informational asymmetries, bilateral monopolies, as well as incomplete contracting. Oliver E. Williamson, *Introduction*, in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 3, 4 (Oliver E. Williamson & Sidney G. Winter eds. 1991). In particular, Williamson emphasizes that uncertainty and

The necessity for a centralized decisionmaker capable of making adaptive changes by fiat thus emerges as the defining characteristic of the Coasean firm.[39] Obviously, fiat within firms has limits. Some choices are barred by contract, such as negative pledge covenants in bond indentures. Other choices may be barred by regulation or statute. Still other choices may be unattractive for business reasons, such as those with potentially adverse reputational consequences. Within such bounds, however, adaptation effected through fiat is the distinguishing characteristic of the firm.

The Coasean central decisionmaker need not be an autocrat, however, as illustrated by the collegial decisionmaking processes of many small firms. Why then do large corporations tend to have hierarchical decisionmaking structures? Kenneth Arrow's seminal work on organizational decisionmaking defined two basic

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complexity do not provide a sufficient explanation for the emergence of ex post governance structures. Instead, one also must introduce some form of asset specificity, of which the most important for present purposes is the firm-specific human capital of the firm's agents. WILLIAMSON, *supra* note 35, at 30-32. For a critique of the transaction cost literature in this area, see Harold Demsetz, *The Theory of the Firm Revisited*, 4 J. L. ECON. & ORG. 141, 144-54 (1988).

[39] In a classic article, Armen Alchian and Harold Demsetz rejected Coase's argument that the power of direction was the factor distinguishing firms from markets. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972). They argued that a firm has no power of fiat; instead, an employer's power to direct its employees does not differ from a consumer's power to direct his grocer. *Id*. at 777-78. Alchian and Demsetz may well be right that Coase erred in treating the firm as a non-market institution in which prices and contracts are of relatively little consequence, but there is no necessary contradiction between a theory of the firm characterized by command-and-control decisionmaking and the contractarian model. The set of contracts making up the firm consists in very large measure of implicit agreements, which by definition are both incomplete and unenforceable. As we have just seen, under conditions of uncertainty and complexity, the firm's many constituencies cannot execute a complete contract, so that many decisions must be left for later contractual rewrites imposed by fiat. It is precisely the unenforceability of implicit corporate contracts that makes it possible for the central decisionmaker to rewrite them more-or-less freely. The parties to the corporate contract presumably accept this consequence of relying on implicit contracts because the resulting reduction in transaction costs benefits them all. It is thus possible to harmonize the Coasean and contractarian models without having to reject a theory of the firm characterized by fiat.

decisionmaking structures: "consensus" and "authority."[40] Consensus is utilized where each member of the organization has identical information and interests and will therefore select the course of action preferred by all the other team members. In contrast, authority-based decisionmaking structures arise where team members have different interests and amounts of information. They are characterized by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions binding on the whole.

It is very hard (if not impossible) to imagine a modern public corporation that could be effectively run using consensus-based decisionmaking mechanisms. Consider the problems faced by shareholders, who are conventionally assumed to be the corporate constituency with the best claim on control of the decisionmaking apparatus.[41] At the most basic level, the mechanical difficulties of achieving consensus amongst thousands of decisionmakers impede shareholders from taking an active role.

Even if those collective action problems could be overcome, however, active shareholder participation in corporate decisionmaking would still be precluded by the shareholders' widely divergent interests and distinctly different levels of information. As to the former, while neoclassical economics assumes that shareholders come to the corporation with wealth maximization as their goal, and most presumably do so, once uncertainty is introduced it would be surprising if shareholder opinions did not differ on which course will maximize share value.[42] As

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[40] KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68-70 (1974).

[41] I follow convention here without attempting to justify the limitation of voting rights to shareholders. For a defense of that convention, see Stephen M. Bainbridge, *Privately Ordered Participatory Management*, 23 DEL. J. CORP. L. 979, 1060-75 (1998).

[42] For example, shareholder investment time horizons are likely to vary from short-term speculation to long-term buy-and-hold strategies, which in turn is likely to result in disagreements about corporate strategy. More prosaically, shareholders in different tax brackets are likely to disagree about such matters as dividend policy, as are shareholders who disagree about the merits of allowing management to invest the firm's free cash flow in new projects. *Cf.* Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 Va. L. Rev. 611, 616 (1995) (stating: "in a world of costly and imperfect information, rational investors are likely to form heterogeneous expectations—that is, to make different forecasts of stocks' likely future performance").

to the latter, shareholders lack incentives to gather the information necessary to actively participate in decisionmaking and thus are rationally apathetic.[43]

Consequently, it is hardly surprising that the modern public corporation's decisionmaking structure precisely fits Arrow's model of an authority-based decisionmaking system. This must be so, because neither shareholders, employees, nor any other constituency have the information or the incentives necessary to make sound decisions on either operational or policy questions.[44] Overcoming the

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[43] A rational shareholder will expend the effort necessary to make informed decisions only if the expected benefits of doing so outweigh its costs. Given the length and complexity of corporate disclosure documents, the opportunity cost entailed in making informed decisions is both high and apparent. In contrast, the expected benefits of becoming informed are quite low, as most shareholders' holdings are too small to have significant effect on the vote's outcome. ROBERT C. CLARK, CORPORATE LAW 390-92 (1986). The problem is compounded by the likelihood that a substantial number of shareholders will attempt to free ride on their fellow shareholders. *Id.* at 392-93.

The efficient capital markets hypothesis provides yet another reason for shareholders to eschew active participation in the governance process. This hypothesis claims that in an efficient market current prices always and fully reflect all relevant publicly available information about the commodities being traded. *See generally* Ronald J. Gilson and Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). (For critiques of the hypothesis, see Donald A. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992); Lynn A. Stout, *How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475 (1997).) If the market is a reliable indicator of performance, as the efficient capital markets hypothesis claims, investors can easily check the performance of companies in which they hold shares and compare their current holdings with alternative investment positions. An occasional glance at the stock market listings in the newspaper is all that is required. Because shareholder apathy makes it easier to switch to an new investment than to fight the incumbent managers, a shareholder need not even know why one firm's performance is faltering. With the expenditure of much less energy than is needed to read corporate disclosure statements, he can simply sell his holdings in the struggling firm and move on to other investments.

[44] In large corporations, the desirability of authority-based decisionmaking structures is enhanced by the division of labor it makes possible. Bounded rationality and complexity, as well as the practical costs of losing time when one shifts jobs, make it efficient for corporate constituents to specialize. Clark, *supra* note 43, at 802. Managers

collective action problems that prevent meaningful involvement by the corporation's various constituencies would be difficult and costly. Under these conditions, Arrow predicts, it is "cheaper and more efficient to transmit all the pieces of information to a central place" and to have the central office "make the collective choice and transmit it rather than retransmit all the information on which the decision is based."[45]

C. Locating the Nexus

American business law allows one to choose between off-the-rack governance systems ranging from an almost pure consensus model—the general partnership—to an almost pure authority model—the public corporation.[46] As Berle and Means famously demonstrated, most public corporations are marked by a separation of ownership and control.[47] Corporate law effectively carves this separation into stone. The key players in the statutory decisionmaking structure are the corporation's directors.[48] As the Delaware code puts it, the corporation's business and affairs "shall be managed by or under the direction of a board of

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specialize in the efficient coordination of other specialists. Directors specialize in the efficient coordination of managers. In order to reap the benefits of specialization, all other corporate constituents should prefer to specialize in functions unrelated to decisionmaking, such as risk-bearing (shareholders) or labor (employees), delegating decisionmaking to managers. Put another way, economies of scale in the information transmission process can be achieved only by elite control of organizations. Kenneth J. Arrow, *Scale Returns in Communication and Elite Control of Organizations*, 7 J. L. ECON. & ORG. (s.i.) 1 (1991). This natural division of labor between capital and management, however, requires that the chosen managers be vested with discretion to make binding decisions. Separating ownership and control by vesting decisionmaking authority in a centralized entity distinct from the corporation's various constituencies thus is what makes the large public corporation feasible.

[45] ARROW, *supra* note 40, at 68-69.

[46] *See* Dooley, *supra* note 17, at 466-68 (comparing partnership and corporate law).

[47] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 84-89 (1932).

[48] All state corporate codes provide for a system of nearly absolute delegation of power to the board of directors, which in turn is authorized to further delegate power to subordinate firm agents. *See* MODEL BUS. CORP. ACT ANN. § 8.01 cmt. (1995) (reviewing statutes).

directors."[49] The vast majority of corporate decisions accordingly are made by the board of directors alone (or by managers acting under delegated authority).[50] Shareholders essentially have no power to initiate corporate action and, moreover, are entitled to approve or disapprove only a very few board actions.[51] The statutory decisionmaking model thus is one in which the board acts and shareholders, at most, react. Put simply, the board is the nexus of contracts.[52] (See Figure 3.)

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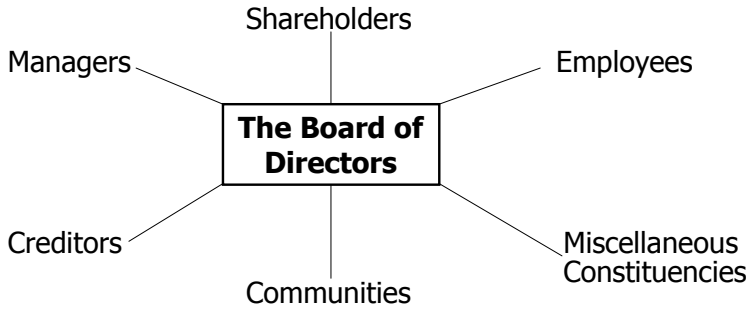
[49] DEL. CODE. ANN., tit. 8, § 141(a) (2001). Of course, operational decisions are normally delegated by the board to subordinate employees. The board, however, retains the power to hire and fire firm employees and to define the limits of their authority. Moreover, certain extraordinary acts may not be delegated, but are instead reserved for the board's exclusive determination. *See, e.g.,* Lee v. Jenkins Bros., 268 F.2d 377 (2d Cir. 1959); Lucy v. Hero Int'l Corp., 281 N.E.2d 266 (Mass. 1972).

[50] The word "decision" is used herein for semantic convenience to describe a process that often is much less discrete in practice. Most board of director activity "does not consist of taking affirmative action on individual matters; it is instead a continuing flow of supervisory process, punctuated only occasionally by a discrete transactional decision." Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1494 (1984).

[51] *See infra* notes 88-103 and accompanying text.

[52] The board of directors as an institution of corporate governance, of course, does not follow inexorably from the necessity for fiat. After all, an individual chief executive could serve as the hypothesized central coordinator. Yet, corporate law vests ultimate control in the board. Why? I have elsewhere suggested two answers to that question: (1) under certain conditions, groups make better decisions than individuals and (2) group decisionmaking is an important constraint on agency costs. Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, __ VAND. L. REV. __ (2002).

Figure 3
Director Primacy:
The firm ***has*** a nexus



D. Distinguishing Director Primacy from Managerialism

Director primacy should not be confused with what might be termed "contractarian managerialism." Although managerialist theories are now passe, there was a time when the leading corporate law theorists embraced such models. In their famous debate, for example, Adolf Berle and E. Merrick Dodd both started with an assumption of managerial discretion. Berle opined, for example, that corporate managers were akin to "princes and ministers."[53] Dodd similarly believed that managers were "free from any substantial supervision by stockholders."[54] They differed only in their policy prescriptions. Berle thought the law should put renewed emphasis on managers' fiduciary duty to maximize

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[53] Adolf Berle, *For Whom Corporate Managers Are Trustees*, 45 HARV. L. REV. 1365, 1366 (1932).

[54] E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?,* 45 HARV. L. REV. 1145, 1147 (1932).

shareholder wealth.[55] In contrast, Dodd argued that corporations have a "social service as well as a profit-making function."[56] The corporate social responsibility debate lives on as the progeny of these arguments.

Both Berle and Dodd erred by failing to distinguish between directors and officers. The board of directors must not be confused with a mere executive committee. Unlike the executive committee of a large law firm partnership, for example, the board of directors is not principally an instrument by which some managers control others. Although the flexible governance rules of partnership and limited liability company law permit such firms to draft operating agreements effecting a substantial separation of ownership and control, such as with a manager-operated LLC, those who control such firms usually retain both day-to-day operating control and a significant equity stake in the enterprise. In contrast, a unique attribute of the modern public corporation is the ever-increasing use of independent board members who typically lack both day-to-day management power and any significant equity stake in the corporation. These characteristics highlight the unique nature of the corporation and its board-based governance system.

To be sure, it is often said that, in the real world, boards are captured by senior management. According to this view, senior "managers dominate their boards by using their de facto power to select and compensate directors and by

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[55] Adolf Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931).

[56] Dodd, *supra* note 54, at 1148. Surprisingly, Berle himself believed that his argument with Dodd "ha[d] been settled (at least for the time being) squarely in favor of Professor Dodd's contention." ADOLF BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION 169 (1954). This concession appears to have been motivated in large part by the New Jersey Supreme Court's decision in A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581 (N.J.), appeal dismissed, 346 U.S. 861 (1953), which upheld a state statute authorizing corporate charitable giving. *See* BERLE, *supra*, at 158 (discussing *Barlow*). In *Barlow*, the court broadly endorsed the corporate social responsibility doctrine. As I have argued elsewhere, however, *Barlow*'s result is not inconsistent with the wealth maximization norm and, in any event, it remains in the minority among the decided cases. Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPPERDINE L. REV. 971, 979 (1992).

exploiting personal ties with them."[57] The board capture phenomenon seems less valid today, however, than it once was. During the 1980s and 1990s, several trends coalesced to encourage more active and effective board oversight. Much director compensation is now paid in stock, for example, which helps align director and shareholder interests.[58] Courts have made clear that effective board processes and oversight are essential if board decisions are to receive the deference traditionally accorded to them under the business judgment rule, especially insofar as structural decisions are concerned (such as those relating to management buy-outs).[59] Third, director conduct is constrained by an active market for corporate control, ever-rising rates of shareholder litigation, and, some say, activist shareholders.[60] As a result, modern boards of directors typically are smaller than their antecedents, meet more often, are more independent from management, own more stock, and have better access to information. These developments culminated in a series of high-profile board revolts against incumbent managers at such iconic American corporations as General Motors, Westinghouse, and American Express.[61] More recently, the firing of "Chainsaw

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[57] Barry Baysinger and Robert E. Hoskisson, *The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy*, 15 ACAD. MGMT. REV. 72, 72-73 (1990).

[58] Charles M. Elson, *Director Compensation and the Management-Captured Board: The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1996).

[59] *See* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1068-81 (1993) (describing how judicial review of management buyouts and other conflict of interest transactions focuses on role of independent directors).

[60] Daniel P. Forbes and Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-making Groups*, 24 ACAD. MGMT. REV. 489 (1999). On the governance role of shareholder activists, see infra notes 98-102 and accompanying text.

[61] *See* Ira M. Milstein, *The Evolution of the Certifying Board*, 48 BUS. LAW. 1485, 1489-90 (1993) (discussing such cases). As boards become stronger and more independent of top management, moreover, the process builds momentum. For example, James Westphal and Edward Zajac have demonstrated that as board power increases relative to the CEO, newly appointed directors become more demographically similar to the board. James D. Westphal and Edward J. Zajac, *Who Shall Govern? CEO/Board Power, Demographic Similarity, and New Director Selection*, 40 ADMIN. SCI. Q. 60

Al" Dunlap by Sunbeam's board provides yet more anecdotal evidence of board activism.[62]

In any event, the institutional structure created by corporate law allows, but does not contemplate, one-man rule. If it comes to overt conflict between the board and top management, the board's authority prevails as a matter of law, if not always in practice. Indeed, it is the necessity for retaining dismissal of senior management as a potential sanction that explains why the board is at the apex of the corporate hierarchy rather than functioning as an advisory committee off to the side of the corporate organizational chart. One can imagine a structure of corporate authority identical to current norms except that the board acts as a mere advisory body to a single autocratic CEO. On the face of it, such a structure seemingly would preserve most advantages of the current structure. Consequently, it is the board's power to hire and fire senior management that explains their position at the apex of the corporate hierarchy. Hence, my emphasis on director rather than managerial primacy.

E. Director v. Shareholder Primacy

Today, most corporate law scholars embrace some variant of shareholder primacy.[63] In its various guises, shareholder primacy contends not only that shareholders are the principals on whose behalf corporate governance is organized, but also that shareholders do (and should) exercise ultimate control of the corporate enterprise. In contrast, director primacy accepts shareholder wealth maximization as the proper corporate decisionmaking norm, but rejects the

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(1995) (measuring power by such factors as the percentage of insiders and whether the CEO also served as chairman; cautioning that CEO control over director selection remains the general rule).

[62] *See* Dana Canedy, *Sunbeam's Board, in Revolt, Ousts Job-Cutting Chairman*, N.Y. TIMES, June 16, 1998, at A1. In most cases, of course, board oversight tends to be both less dramatic and more informal. Individual directors pass concerns onto the CEO, who in turn bounces ideas off board members. Rather than struggling to overcome the collective action problems that impede firing a CEO, an individual director tries to obtain better performance through a private reprimand.

[63] *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440-41 (2001) (describing the "standard shareholder-oriented" model).

notion that shareholders are entitled to either direct or indirect decisionmaking control.

Two variants of shareholder primacy compete. The key difference between them models relates to the nature of ownership with respect to the firm: What do shareholders own? Traditional scholars contend that shareholders own the firm itself. Agency cost-oriented scholars typically contend that shareholders the residual claim to the corporation's assets and earnings. In either case, shareholders occupy a privileged position with ownership-like rights. Directors and officers are mere agents of the shareholders. As we shall see, however, both traditional and agency cost models are flawed.

1. The Ownership Variant of Shareholder Primacy

Nobel laureate economist Milton Friedman's famous essay corporate social responsibility remains the classic statement of the traditional shareholder primacy model:

> In a free enterprise, private-property system, a corporate executive is an employe of the owners of the business. He has [a] direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of society ....
>
> ... Insofar as his actions in accord with his "social responsibility" reduce returns to stockholders, he is spending their money.[64]

Note that Friedman treats stockownership as a species of private property. Implicit in his model, accordingly, is a conception of the corporation as a thing capable of being owned.[65] Because private property is such a profound part of the

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[64] Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 32, 33.

[65] Melvin Eisenberg recently argued that shareholders possess most of the incidents of ownership, which he identified as including "the rights to possess, use, and manage, and the rights to income and capital." Eisenberg, *supra* note 28, at 825. Accordingly, he argued, shareholders own the corporation. *Id.* In fact, however, shareholders have no right to use or possess corporate property. *Cf.* W. Clay Jackson Enterprises, Inc. v. Greyhound Leasing and Financial Corp., 463 F. Supp. 666, 670 (D. P.R. 1979) (stating that "even a sole shareholder has no independent right which is violated by trespass upon or conversion of the corporation's property"). Management rights, of course, are assigned by statute solely to the board of directors and those officers to whom the board

American ethos, this model's normative implications long dominated our approach to corporate law.

In contrast, contractarians reject the idea that the firm is a thing capable of being owned. [66] Recall that the firm is—or has—a nexus for the set of contracts by which various factors of production are hired. Someone owns each of those factors, but no one owns the nexus itself. To be sure, shareholders own the residual claim on the corporation's assets and earnings.[67] At bottom, the ownership of that claim is why the set of contracts making up the corporation

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properly delegates such authority. *See supra* text accompanying note 49. Indeed, to the extent that possessory and control rights are the indicia of a property right, the board is a better candidate for identification as the corporation's owner than are the shareholders. As an early New York opinion put it, "the directors in the performance of their duty possess [the corporation's property], and act in every way as if they owned it." Manson v. Curtis, 119 N.E. 559, 562 (N.Y. 1918).

[66] At least where transaction costs are low, moreover, any rights conferred by "ownership" can be undone by contract. Admittedly, of course, transaction costs are often high with respect to the shareholder and employee constituents of a public corporation. Economist Oliver Hart's so-called property rights theory of the firm contends that ownership rights become important in high transaction cost settings, because contracts written in such settings are inherently incomplete. *See* Oliver D. Hart, *Incomplete Contracts and the Theory of the Firm*, J. L. ECON. & ORG. 119 (1988). Hart defines the "rights of ownership" as the "residual rights of control." *Id*. at 123 (emphasis deleted). Under conditions producing incomplete contracts, residual control rights take on importance as a gap-filling mechanism. Given the limited control rights given shareholders by corporate law, however, the property rights model has limited utility with respect to public corporations. As with the rights of other corporate constituents, the rights of shareholders are established through bargaining, even though the form of the bargain is a take it or leave it standard form contract provided off the rack by the default rules of corporate law. For an overview of the distinctions between transaction cost and property rights models of firm, Bengt Hölmstrom & John Roberts, *The Boundaries of the Firm Revisited*, 12 J. ECON. PERSP. 73, 75-79 (1998).

[67] *See generally* Eugene F. Fama & Michael C. Jensen, *Organizational Forms and Investment Decisions*, 14 J. FIN. ECON. 101, 102-03 (1985) (arguing that shareholders hold the residual claim and will prefer a rule maximizing the market value of that residual claim); *see also* OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 184 (1996) (arguing that shareholders have residual claimant status with respect to both earnings and asset liquidation).

treats the shareholders as the beneficiaries of director accountability.[68] Yet, ownership of the residual claim is not the same as ownership of the firm itself. Hence, we can throw Friedman's concept of ownership out the window, along with its associated economic and ethical baggage.

2. The Agency Cost Variant of Shareholder Primacy

Although there is no necessary connection between the two, agency cost economics and the contractarian theory of the firm are conflated by most scholars.[69] In the agency cost variant of shareholder primacy, directors and officers are deemed agents of the shareholders, who in turn are viewed as principals.[70] Scholars working in this model are therefore concerned mainly with shirking by directors and managers.[71]

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[68] *See infra* Part III.B.

[69] *See* Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283, 295 (1998) (stating: "Many contractarians believe that the fundamental concern of corporate law is 'agency costs' ...."); D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons From Kmart*, 74 N.C. L. REV. 1037, 1059 (1996) (stating: "Under the contractarian model, the purpose of the corporate governance system is the minimization of agency costs."); *see, e.g.,* Barry D. Baysinger & Henry N. Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431, 437 n.19 (1985) (opining that "shirking ... is endemic to the principal-agent relationship which defines the open corporation"); Henry N. Butler & Fred S. McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation,* 84 CORNELL L. REV. 1195, (1999) (noting the "the contractarian notion of the corporation with its focus on agency costs").

[70] *See, e.g*., Baysinger & Butler, *supra* note 69, at 436 (arguing that the "modern corporation ... presents a nearly perfect example of an agency relationship: individuals with delegated authority (agents) exercise that authority on behalf of others (principals) for a fee"); *see also* Friedman, *supra* note 64, at 33 (stating that "a corporate executive is an employe of the owners of the business").

[71] Agency costs are defined as the sum of the monitoring and bonding costs, plus any residual loss, incurred to prevent shirking by agents. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 304 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. ECON. 305, 308 (1976). In turn, shirking is defined to

As the theory goes, agents do not internalize all of the costs of shirking, because while the principal reaps part of the value of hard work by the agent, the agent receives all of the value of shirking.[72] Despite the resulting ex post incentives to shirk, however, agents also have ex ante incentives to agree to contract terms designed to prevent shirking.[73] Bounded rationality and other transaction costs, however, precludes firms and agents from entering into the complete contract necessary to prevent shirking by the latter. Instead, there must be some system of ex post governance: some mechanism for detecting and punishing shirking.[74]

The existence of such monitoring systems is obvious in M-form corporations. This firm type has two defining characteristics: many distinct operating units and management by a hierarchy of salaried executives.[75] Just as a branching corporate hierarchy facilitates the flow of information within such firms,[76] it also facilitates

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include any action by a member of a production team that diverges from the interests of the team as a whole. As such, shirking includes not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes. Dooley, *supra* note 17, at 465. In other words, shirking is simply the inevitable consequence of bounded rationality and opportunism within agency relationships. *See generally* Roy Radner, *Hierarchy: The Economics of Managing*, 30 J. ECON. LIT. 1382, 1405-07 (1992) (identifying the incentives of rational agents to shirk).

[72] *See* BERLE & MEANS, *supra* note 47, at 6 (stating: "The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge and where many of the checks which formerly operated to limit the use of power disappear.").

[73] Alchian & Demsetz, *supra* note 39, at 781; Jensen & Meckling, *supra* note 71, at 325-26.

[74] *See* Alchian & Demsetz, *supra* note 39, at 794 (explaining that an essential economic function of management is monitoring the various inputs into the team effort—management meters the marginal productivity of each team member and then takes steps to reduce shirking).

[75] CHANDLER, supra note 6, at 1.

[76] Corporate hierarchies generally are an efficient mechanism for information development and transmittal. Bounded rationality places limits on the ability of individuals to gather and process information, which implies that an individual manager can gather information about the capacities of only a limited number of production units and that no supervisor should receive such information from more than a few subordinates. Branching hierarchies solve this problem by limiting the span of control over which any individual

monitoring.[77] It would be difficult, at best, for a plant manager with hundreds of employees to determine which deserve rewards and which deserve reprimands. Such a task obviously becomes impossible long before we reach the board of directors of a large public corporation. A branching hierarchy provides a ready solution. The board delegates responsibility to senior management and monitors their performance.[78] The senior managers in the firm's central office delegate responsibility to managers of operating units.[79] In turn, the managers of each operating unit are responsible for monitoring the productivity of their unit.[80] The process continues down to the foreman on the shop floor. Creating such a branching hierarchy addresses the problems of uncertainty, bounded rationality, and shirking faced by monitors in all team situations by breaking the firm team into discrete segments, each of which is more readily monitored than the whole. At each hierarchical level, the responsible monitor is responsible for supervising only a few individuals, which usefully limits and focuses his task.

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manager has supervision to a small number of subordinates. Specifically, branching hierarchies put people into small groups, each member of which reports information to the same supervisor. That supervisor is likewise a member of a small group that reports to a superior and so on up to the top. In most cases, such an organizational system gets reliable information to the right decisionmaker more efficiently than any other organizational system. Not surprisingly, some form of branching hierarchy therefore tends to be found in most public corporations: they could not make decisions without it. For a detailed defense of this proposition, and corporate hierarchies generally, see CLARK, *supra* note 43, at 801-16. For a description of circumstances under which hierarchy ceases to be an efficient information transmission mechanism, see Bainbridge, *supra* note 41, at 1011-14.

[77] WILLIAMSON, *supra* note 35, at 289 (stating: "the organizational logic of the M-form structure runs very deep—serving, as it does, both to economize on bounded rationality ... and safeguard the internal resource allocation process against the hazards of opportunism").

[78] Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1225 (1984).

[79] The central office is critical to understanding monitoring in M-form corporations. The monitoring mechanisms described in the text could be accomplished through a simple pyramidal hierarchy of the sort found in U-form corporations. The M-form corporation adds to this structure a rationalization of decisionmaking authority in which the central office has certain tasks and the operating units have others, which allows for more effective monitoring through specialization, sharper definition of purpose, and savings in informational costs. WILLIAMSON, *supra* note 35, at 320.

[80] Williamson, *supra* note 78, at 1219-20.

The structure just described, however, raises the question of who will monitor the monitors?[81] In any team organization, one must have some ultimate monitor who has sufficient incentives to ensure firm productivity without himself having to be monitored. Otherwise, one ends up with a never ending series of monitors monitoring lower level monitors. Armen Alchian and Harold Demsetz solved this dilemma by consolidating the roles of ultimate monitor and residual claimant: If the constituent entitled to the firm's residual income is given final monitoring authority, he is encouraged to detect and punish shirking by the firm's other inputs because his reward will vary exactly with his success as a monitor.[82]

Unfortunately, this elegant theory breaks down precisely where it would be most useful. Because of the separation of ownership and control, it simply does not describe the modern publicly-held corporation. As the corporation's residual claimants, the shareholders should act as the firm's ultimate monitors. But while the law provides shareholders with some enforcement and electoral rights, these are reserved for fairly extraordinary situations.[83] In general, shareholders of public corporations have neither the legal right, the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation's agents.

Agency cost economics thus applies only imperfectly to the modern public corporation.[84] To be clear, the claim is not that agency cost models are irrelevant

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[81] Alchian & Demsetz, *supra* note 39, at 782.

[82] *Id*. at 781-83.

[83] Derivative suits and proxy contests, for example, constrain managerial behavior to some extent. These remedies are so costly and their outcome so uncertain that they are invoked only episodically. Moreover, many aspects of the legal rules governing these devices (such as the derivative suit demand requirement, the federal proxy regulations, and state rules governing reimbursement of expenses) seem calculated to discourage frequent recourse to them. Dooley, *supra* note 35, at 525.

[84] A more general problem, which also detracts from the utility of agency cost economics as an explanation for corporate governance institutions, is that agency cost economics posits that all relevant contracting issues can be resolved in a comprehensive ex ante bargain that can be efficaciously enforced by courts. WILLIAMSON, *supra* note 35, at 28. This approach does not adequately model the modern public corporation in which incomplete contracts are common, governance is typically ex post, and various legal doctrines preclude active judicial oversight of internal disputes. *Cf.* Harold Demsetz, *The*

to understanding the public corporation. The claim is only that such models are incomplete.[85] Agency costs are the inevitable consequence of vesting discretion in someone other than the residual claimant. We could substantially reduce, if not eliminate, agency costs by eliminating discretion. That we do not do so suggests something else must be going on here.

3. Shareholder Primacy and the Tension Between Authority and Accountability

Shareholder primacy posits a governance system decisionmaking model in which ultimate control rests with the shareholders. Ultimate shareholder control is necessary, *inter alia*, to constrain agency costs.[86] Hence, for example, shareholder primacy assumes shareholder voting rights that are both exclusive and strong.[87]

In fact, however, shareholder control rights are so weak that they scarcely qualify as part of corporate governance. Instead, we vest nonreviewable

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Theory of the Firm Revisited, 4 J. L. ECON. & ORG. 141, 152 (arguing that agency costs models cannot explain the existence of the firm as an institution).

[85] Agency costs models are particularly problematic when used to justify state regulation of corporate governance. Corporate managers operate within a pervasive web of accountability mechanisms that substitute for monitoring by residual claimants. Important constraints are provided by a variety of market forces. The capital and product markets, the internal and external employment markets, and the market for corporate control all constrain shirking by firm agents. In addition, the market evolved various adaptive responses to the ineffectiveness of shareholder monitoring, establishing alternative accountability structures to punish and deter wrongdoing by firm agents, most notably the board of directors.

[86] Hansmann & Kraakman, *supra* note 63, at 444 (noting "the conventional wisdom that, when managers are given great discretion over corporate investment policies, they tend to serve disproportionately their own interests").

[87] *See id.* at 449 (making that assumption). Judicial oversight of board decisions in litigation initiated by shareholders provides an indirect mechanism of shareholder control. The business judgment rule, however, insulates most board decisionmaking from review. *See infra* Part IV.E. The procedural restrictions on shareholder litigation further limit the utility of judicial oversight as a means of shareholder control. *See supra* note 83. Consequently, shareholder litigation is better understood as a limited mechanism for ensuring accountability than as a means of exercising control.

discretionary fiat in the board of directors. Under the Delaware code, for example, shareholder voting rights are essentially limited to the election of directors and approval of charter or by-law amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolution.[88] As a formal matter, only the election of directors and amending the by-laws do not require board approval before shareholder action is possible.[89] In practice, of course, even the election of directors (absent a proxy contest) is predetermined by the existing board nominating the next year's board.[90]

These direct restrictions on shareholder power are supplemented by a host of other rules that indirectly prevent shareholders from exercising significant influence over corporate decisionmaking. Three sets of statutes are especially noteworthy: (1) disclosure requirements pertaining to large holders;[91] (2) shareholder voting and communication rules;[92] (3) insider trading and short

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[88] *See* DOOLEY, *supra* note 13, at 174-77 (summarizing shareholder voting rights).

[89] DEL. CODE ANN., tit. 8, §§ 109, 211 (2000).

[90] *See generally* Bayless Manning, *Book Review*, 67 YALE L.J. 1477, 1485-89 (1958) (describing incumbent control of the proxy voting machinery).

[91] Securities Exchange Act § 13(d) and the SEC rules thereunder require extensive disclosures from any person or group acting together which acquires beneficial ownership of more than 5 percent of the outstanding shares of any class of equity stock in a given issuer. 15 U.S.C. § 78m (2001). The disclosures required by § 13(d) impinge substantially on investor privacy and thus may discourage some investors from holding blocks greater than 4.9% of a company's stock. U.S. institutional investors frequently cite Section 13(d)'s application to groups and the consequent risk of liability for failing to provide adequate disclosures as an explanation for the general lack of shareholder activism on their part. Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459, 461 (1998).

[92] To the extent shareholders exercise any control over the corporation, they do so only through control of the board of directors. As such, it is the shareholders' ability to affect the election of directors that determines the degree of influence they will hold over the corporation. The proxy regulatory regime discourages large shareholders from seeking to replace incumbent directors with their own nominees. *See* Stephen M. Bainbridge, *Redirecting State Takeover Laws at Proxy Contests*, 1992 WIS. L. REV. 1071, 1075-84 (describing incentives against proxy contests). It also discourages shareholders from communicating with one another. *See* Stephen Choi, *Proxy Issue*

swing profits rules.[93] These laws affect shareholders in two respects. First, they discourage the formation of large stock blocks.[94] Second, they discourage communication and coordination among shareholders.[95]

Despite the limitations of shareholder voting rights, some scholars argue the market for corporate control ensures a residual form of shareholder control, transforming "the limited de jure shareholder voice into a powerful de facto form of shareholder control."[96] To be sure, the market for corporate control depends on the existence of shareholder voting rights. Yet, while it is fair to say that the market for corporate control is an important accountability mechanism, market-based accountability and control—by which I mean the right to exercise decisionmaking fiat—are distinct concepts. Directors are held accountable to shareholders through a variety of market forces, moreover, such as the capital and reputational markets, but one cannot fairly say that those markets confer control rights on the shareholders. How then can one say that the market for corporate control does so? The right to fire is not the right to exercise fiat—it is

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Proposals: Impact of the 1992 SEC Proxy Reforms, 16 J. L. ECON. & ORG. 233 (2000) (explaining that liberalization of the proxy rules has not had a significant effect).

[93] *See* Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J. L. & PUB. POL'Y 671, 712-13 (1995) (noting insider trading concerns raised by shareholder activism).

[94] Large block formation may also be discouraged by state corporate law rules governing minority shareholder protections. Under Delaware law, a controlling shareholder has fiduciary obligations to the minority. *See, e.g.*, Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947). A controlling shareholder who uses its power to force the corporation to enter into contracts with the shareholder or its affiliates on unfair terms can be held liable for the resulting injury to the minority. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971). A controlling shareholder who uses its influence to effect a freeze-out merger in which the minority shareholders are bought out at an unfairly low price likewise faces liability. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

[95] For a more detailed treatment of the effects of these statutes on shareholder control, see Stephen M. Bainbridge, *Constraints on Shareholder Activism in the United States and Slovenia* (2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=228780.

[96] John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable are U.S. Public Corporations?,* 24 J. CORP. L. 837, 850 (1999).

only the right to discipline. In any event, takeover defenses—especially the combination of a poison pill and a classified board—go along way towards restoring director primacy vis-à-vis the shareholders.[97]

Other scholars have argued that institutional investor activism can give real teeth to shareholder control.[98] Acknowledging that the rational apathy phenomenon precludes small individual shareholders from playing an active role in corporate governance, even if the various legal impediments to shareholder activism were removed, these scholars focused their attention on institutional investors, such as pension and mutual funds. Institutional investors, at least potentially, may behave quite differently than dispersed individual investors. Because they own large blocks, and have an incentive to develop specialized expertise in making and monitoring investments, they could play a far more active role in corporate governance than dispersed shareholders. Institutional investors holding large blocks thus have more power to hold management accountable for actions that do not promote shareholder welfare. Their greater access to firm information, coupled with their concentrated voting power, might enable them to more actively monitor the firm's performance and to make changes in the board's composition when performance lagged.

There is relatively little evidence that institutional investor activism has mattered, however. Due to a resurgence of direct individual investment in the stock market, motivated at least in part by the day trading phenomenon and the

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[97] *See* Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 125-26 (2001) (discussing effectiveness of pill-classified board combination as a means of ensuring continued board control); *see also* Robert B. Thompson, *Shareholders as Grown-Ups: Voting, Selling, and Limits on the Board's Power to "Just Say No,"* 67 U. CIN. L. REV. 999, 1017-18 (1999) (using legal treatment of poison pill and classified board provisions as a measure of jurisdictional commitment to shareholder primacy).

[98] See, e.g., MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990). For more skeptical analyses, see Edward Rock, *The Logic and Uncertain Significance of Institutional Investor Activism*, 79 GEO. L.J. 445 (1991); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993); Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163 (1991).

technology stock bubble, the trend towards institutional domination has stagnated. Although about 50% of equity securities are still owned by institutions, large blocks held by a single investor are rare, and few U.S. corporations have any institutional shareholders who own more than 5-10% of their stock.[99] Even the most active institutional investors spend only trifling amounts on corporate governance activism. Institutions devote little effort to monitoring management; to the contrary, they typically disclaim the ability or desire to decide company-specific policy questions.[100] They rarely conduct proxy solicitations or put forward shareholder proposals.[101] Not surprisingly, empirical studies of U.S. institutional investor activism have found "no strong evidence of a correlation between firm performance and percentage of shares owned by institutions."[102]

In sum, shareholders are almost wholly lacking in either direct or indirect mechanisms of control. Likewise, there is little evidence of effective shareholder demand for such control. Instead, the nonreviewability of board decisions seems to be an inherent characteristic of the corporate form. As Williamson puts it, "hierarchy is its own court of ultimate appeal."[103]

If the constraints on shareholder control provided by corporate and securities law have an efficiency justification, that justification therefore must rest on a model of the corporation other than shareholder primacy. The thesis of this Article is that director primacy, with its emphasis on authority and fiat, provides just such a model. In contrast to shareholder primacy, the director primacy model takes contractarian theory to its logical extreme by severing the link between means and ends—i.e., the allocation of control and the identification of legitimate corporate ends. Director primacy does not deny that the proper "end" of corporate governance is shareholder wealth maximization.[104] Director primacy claims, however, that the powers of the board of directors are neither delegated to

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[99] *See* Black, *supra* note 98, at 567-68 (summarizing data).

[100] Black, *supra* note 91, at 460.

[101] *Id*. at 459-60.

[102] *Id*. at 462.

[103] WILLIAMSON, *supra* note 67, at 98.

[104] *See infra* Part III.

the board by shareholders nor usurped by the former. Instead, as an early New York decision put it, the board's powers are "original and undelegated."[105]

As suggested by my argument that the board is the true nexus of contracts, the chief economic virtue of the public corporation is not that it permits the aggregation of large capital pools, but rather that it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs. In such a firm, someone must be in charge: "Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success."[106] In other words, someone must possess the right to make by fiat decisions binding on the whole.

Shareholder primacy is inconsistent with the efficient exercise of fiat. Shareholder oversight of board decisions would necessarily contemplate that investors may review management decisions, step in when management performance falters, and exercise voting control to effect a change in policy or personnel. In a very real sense, giving investors this power of review differs little from giving them the power to make management decisions in the first place. As Kenneth Arrow observed: "If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.[107] Indeed, if shareholders could routinely review board decisions, the directors' power of fiat would become merely advisory, rather than authoritative. The efficient separation of ownership and control that makes the modern corporation possible thus is inconsistent with shareholder primacy.

Put more generally, a complete theory of the firm requires one to balance the virtues of fiat against the need to ensure that fiat is exercised responsibly.[108] Neither discretion nor accountability can be ignored, because both promote values essential to the survival of business organizations. Unfortunately, they are ultimately antithetical: one cannot have more of one without also having less of the other.[109] At

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[105] Manson v. Curtis, 119 N.E. 559, 562 (N.Y. 1918).

[106] ARROW, *supra* note 40, at 69.

[107] *Id.* at 78.

[108] Dooley, *supra* note 17, at 464-71.

[109] *Id.* at 470.

some point, directors cannot be made more accountable without undermining their discretionary authority.

Establishing the proper mix of discretion and accountability thus emerges as the central corporate governance question. Given the significant virtues of fiat, however, one must not lightly interfere with the board's decisionmaking authority in the name of accountability. Consequently, insofar as the means axis of Figure 1 is concerned, the central thesis of director primacy is that preservation of the board's power of fiat should always be the null hypothesis.

III. THE ENDS AXIS (PART I): DIRECTOR PRIMACY V. STAKEHOLDERIST MODELS

Although they are often used interchangeably, the terms shareholder primacy and shareholder wealth maximization express distinct concepts. As we have seen, shareholder primacy incorporates a decisionmaking model vesting ultimate control rests in the shareholders. In rejecting that model, director primacy does not throw out the baby with the bath water. The eponymous shareholder wealth maximization norm charges directors with managing the corporation so as to maximize shareholder wealth. As a bargained-for contract right of the shareholders, the norm plays a central role in the director primacy model.

A. Shareholder Wealth Maximization in Law and Practice

To what extent should the fiduciary duties of corporate directors permit them, or even require them, to consider nonshareholder interests when making corporate decisions? Corporate law's classical answer famously was articulated in *Dodge v. Ford Motor Co.*[110] Henry Ford embarked on a plan of retaining earnings, lowering prices, improving quality, and expanding production. The plaintiff Dodge brothers contended an improper altruism towards his workers and customers motivated Ford. The court agreed, strongly rebuking Ford:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits,

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[110] 170 N.W. 668 (Mich. 1919).

> or to the nondistribution of profits among stockholders in order to devote them to other purposes.[111]

Consequently, "it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others."[112] *Dodge*'s theory of shareholder wealth maximization has been widely accepted by courts over an extended period of time. Almost three quarters of a century after *Dodge*, the Delaware chancery court similarly opined: "It is the obligation for directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders."[113]

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[111] *Id.* at 684.

[112] *Id*.

[113] Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1989). For an interesting interpretation of *Dodge*, which argues that the shareholder wealth maximization norm originated as a means for resolving disputes among majority and minority shareholders in closely held corporations, see D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998). I am skeptical of Smith's interpretation. In the first instance, the court's own analysis in *Dodge* is not limited to close corporations. Smith places considerable emphasis on the sentence immediately preceding the court's statement of the shareholder wealth maximization norm. *See id*. at 319 (using italics for emphasis). In that sentence, the court draws a distinction between the duties Ford believed he and his fellow stockholders owed to the general public "and the duties which in law *he and his codirectors* owe to protesting, minority stockholders." *Dodge*, 170 N.W. at 684 (emphasis supplied). On its face, the duty to which the court refers is that of a director rather than the duties of a majority shareholder. (Concedely, both the specific passage in question and the opinion in general are sufficiently ambiguous to permit Smith's interpretation.) In the second instance, whatever *Dodge* originally meant, the evolutionary processes of the common law have led to *Dodge* being interpreted as establishing a basic rule for boards of directors; namely, that the board has a duty to maximize shareholder wealth. In Long v. Norwood Hills Corp., 380 S.W.2d 451 (Mo. Ct. App. 1964), for example, the court observed:

> Plaintiff cites many authorities [including *Dodge*] to show that the ultimate object of every ordinary trading corporation is the pecuniary gain of its stockholders and that it is for this purpose the capital has been advanced.... All of these cases involve either banking, commercial or manufacturing corporations and in most of them alleged misappropriation of the assets of the

Shareholder wealth maximization is not only the law, it is also a basic feature of corporate ideology. Although some scholars claim that directors do not adhere to the shareholder wealth maximization norm, the weight of the evidence is to the contrary.[114] A 1995 National Association of Corporate Directors (NACD) report stated: "The primary objective of the corporation is to conduct business activities with a view to enhancing corporate profit and shareholder gain."[115] A 1996 NACD report on director professionalism set out the same objective, without any qualifying language on nonshareholder constituencies.[116] A 1999 Conference Board survey found that directors of U.S. corporations generally define their role as running the company for the benefit of its shareholders.[117] The 2000 edition of Korn/Ferry International's well-known director survey found that when making corporate decisions directors consider shareholder interests most frequently, although it also found that a substantial number of directors feel a responsibility towards stakeholders.[118]

What people do arguably matters more than what they say. Director fidelity to shareholder interests has been enhanced in recent years by the market for corporate control and, some say, activism by institutional investors. Hence, for example, the widespread corporate restructurings of the 1990s are commonly

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> corporation or misconduct of the majority stockholders or *boards of directors* have been alleged.

Id. at 476 (emphasis supplied). The court further stated that it had "no quarrel with plaintiff insofar as the rules of law stated therein govern the actions of majority stockholders *and* the boards of directors of corporations." *Id* (emphasis supplied). As Smith himself concedes, moreover, his interpretation departs from the "consensus" of most corporate law scholars. Smith, *supra*, at 283.

[114] *See, e.g.,* Blair & Stout, *supra* note 18, at 286; Smith, *supra* note 113, at 290-91.

[115] NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, REPORT OF THE NACD BLUE RIBBON COMMISSION ON DIRECTOR COMPENSATION: PURPOSES, PRINCIPLES, AND BEST PRACTICES 1 (1995) (noting, however, that "long-term shareholder gain" requires "fair treatment" of nonshareholder constituents).

[116] *See* NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, REPORT OF THE NACD BLUE RIBBON COMMISSION ON DIRECTOR PROFESSIONALISM 1 (1996).

[117] THE CONFERENCE BOARD, DETERMINING BOARD EFFECTIVENESS: A HANDBOOK FOR DIRECTORS AND OFFICERS 7 (1999).

[118] KORN/ FERRY INTERNATIONAL, 27TH ANNUAL BOARD OF DIRECTORS STUDY 33-34 (2000).

attributed to director concern for shareholder wealth maximization.[119] In addition, changes in director compensation have created additional hostages ensuring director fidelity to shareholder interests.[120] Directors have long given shareholders reputational hostages. If the company fails on their watch, after all, the directors' reputation and thus their future employability is likely to suffer.[121] In addition, it is becoming common to compensate outside directors in stock rather than cash and to establish minimum stock ownership requirements as a qualification for election.[122] Tying up the proportion of the director's personal wealth in stock of the corporation creates another hostage, further aligning the director's interests with those of shareholders.[123]

B. Shareholder Wealth Maximization Norm and the Nexus of Contracts Model

The question here is whether the concept of director accountability for shareholder wealth maximization can be squared with the contractarian account. Because ownership is not a meaningful concept in the contractarian model, contractarianism seems wholly inconsistent with the traditional views espoused

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[119] *See, e.g.,* MICHAEL USEEM, INVESTOR CAPITALISM: HOW MONEY MANAGERS ARE CHANGING THE FACE OF CORPORATE AMERICA 137-67 (1996) (discussing corporate restructurings as a consequence of investor pressure).

[120] Hostages—reciprocal transaction-specific investments—are a central concept in institutional economics. Giving and taking hostages is a mechanism for making credible commitments. I'll pay the ransom, because I know that you will kill the hostage if I do not. *See* Williamson, *supra* note 67, at 75-78 and 124-29 (discussing the hostage model of contracting).

[121] *Cf.* Fama & Jensen, *supra* note 71, at 315 (opining that "outside directors will monitor the management that chooses them because outside directors have incentives to develop reputations as experts in decision control").

[122] *See generally* Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649 (1995) (discussing stock-based director compensation and incentives created thereby).

[123] *See Outside Directors: The Fading Appeal of the Boardroom*, THE ECONOMIST, Feb. 20, 2001, at 67, 69 (relating an anecdote in which one outside director who owned $500,000 worth of corporate stock stated: "If this company faces a challenge, I lose sleep at night").

in cases like *Dodge* or by scholars like Friedman. The director primacy variant of contractarianism, which treats the board of directors as a sort of Platonic guardian, whose power devolves from the set of contracts making up the corporation as a whole rather than solely from shareholders, looks especially like a stakeholderist model. Yet, contractarianism and shareholder wealth maximization are not inconsistent. One reconciles them by affirmatively answering the following question: Would a shareholder wealth maximization norm emerge from the hypothetical bargain as the majoritarian default?

1. The Hypothetical Bargain Methodology

The contractarian model has important implications for a range of corporate law topics, the most obvious of which is the debate over the proper role of mandatory legal rules. As a positive matter, contractarians contend that corporate law is comprised mainly of default rules, from which shareholders are free to depart, rather than mandatory rules. As a normative matter, contractarians think this is just as it should be.[124]

If corporate law consists mainly of default rules, corporate statutes and decisions can be viewed as a standard form contract voluntarily adopted—perhaps with modifications—by the corporation's various constituencies.[125] The point of a standard form contract, of course, is to reduce bargaining costs. Parties for whom the default rules are a good fit can take the default rules off the rack, without having to bargain over them. Parties for whom the default rules are inappropriate are free to bargain out of the default rules.

If transaction costs are zero, the default rules—whether contained in a statute or a private standard form contract—do not matter very much.[126] In the face of

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[124] *See, e.g.*, Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 984, 989-91 (1993).

[125] Providing a standard form contract, of course, is not the sole function of corporation law. Law also provides institutional features that could not be effected by internal contracts. *See, e.g.*, Hansmann & Kraakman, *supra* note 63, at 406-23 (arguing that parties could not effect affirmative asset partitioning by contract). The firm thus has both contractual and institutional attributes.

[126] This is a straightforward application of the Coase Theorem, which asserts that, in the absence of transaction costs, the initial assignment of a property right will not

positive transaction costs, however, the default rule begins to matter quite a lot. Indeed, if transaction costs are very high, bargaining around the rule becomes wholly impractical, forcing the parties to live with an inefficient rule. In such settings, we cannot depend on private contracting to achieve efficient outcomes. Instead, statutes must function as a substitute for private bargaining. The public corporation—with its thousands of shareholders, managers, employees, and creditors, each with different interests and asymmetrical information—is a very high transaction cost environment indeed.

Identifying the party for whom getting its way has the highest value thus becomes the critical question. In effect, we must perform a thought experiment: "If the parties could costlessly bargain over the question, which rule would they adopt?" In other words, we mentally play out the following scenario: Sit all interested parties down around a conference table before organizing the corporation. Ask the prospective shareholders, employees, contract creditors, tort victims, and the like to bargain over what rules they would want to govern their relationships. Adopt that bargain as the corporate law default rule. Doing so reduces transaction costs and therefore makes firms more efficient. Of course, we cannot really do this, but we can draw on experience and economic analysis to predict what the parties would do in such a situation.[127]

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determine its ultimate use. *See* R. H. COASE, THE FIRM, THE MARKET, AND THE LAW 157-59 (1988) (describing the Coase theorem).

[127] The basic thesis of the hypothetical bargain methodology is that by providing the rule to which the parties would agree if they could bargain (the so-called "majoritarian default"), society facilitates private ordering. In an important series of articles, however, Ian Ayres and his collaborators argued that majoritarian defaults are not always desirable, even if a potentially dominant one can be identified. *See, e.g.,* Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391 (1992); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027 (1995). For a defense of majoritarian defaults, see Stephen M. Bainbridge, *Contractarianism in the Business Associations Classroom:* Kovacik v. Reed *and the Allocation of Capital Losses in Service Partnerships*, 34 GA. L. REV. 631, 651-59 (2000). In any event, Ayres himself regards his analysis as qualifying, but not refuting the hypothetical bargain methodology. Ayres, *supra*, at 1419.

2. Identifying the Bargainers

As a preliminary matter, we need to identify the relevant participants in the hypothetical bargain. Arguably, one could focus on a hypothetical bargain between shareholders and nonshareholder constituencies. Alternatively, one could focus on bargaining between shareholders and the entity as nexus.[128] Because the director primacy model treats the corporation as a vehicle by which directors hire capital, however, the focus here is on bargaining between shareholders and the board directors.

As explained in the next section, directors and shareholders would strike a bargain in which directors pursue shareholder wealth maximization. Shareholders will insist on that norm when entering into their contract with the corporation or, at least, would be willing to pay more for stock protected by that norm. Because directors have an incentive to minimize the firm's cost of capital, they will agree to be bound by the norm.

This result does not change even if we introduce into the mix nonshareholder constituencies as a bargaining party. Director pursuit of shareholder wealth maximization often redounds to the benefit of nonshareholder constituencies. Even where shareholder and nonshareholder interests conflict, moreover, nonshareholders receive superior protection from contracts and both targeted and general welfare legislation. Because shareholders will place a higher value on being the beneficiaries of director fiduciary duties than will non shareholder constituencies, gains from trade are available, and we would expect a bargain to be struck in which shareholder wealth maximization is the chosen norm.

3. The Bargain Over Ends

Given the substantial discretion vested in the board, directors could pursue their own personal self-interest. Alternatively, directors could pursue personal policy preferences, such as favoring the interests of employees over those of other corporate constituents. Yet, despite director primacy, boards do not insist on unfettered discretion. Instead, boards voluntarily limit their discretion with respect to the proper ends of corporate governance by embracing the shareholder wealth maximization norm. Why?

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[128] *See supra* note 28 and accompanying text.

Return is positively correlated with risk.[129] If directors expose shareholders to greater risk, shareholders will demand a higher rate of return. Greater risk thus translates directly into a higher corporate cost of capital. At the margins, a higher cost of capital increases the probability of firm failure or takeover.

But why do directors care? First, there are reputational costs to firm failure.[130] Second, to the extent the directors invest in firm specific human capital, that investment will be lost if the directors lose their positions following a firm failure or takeover. Third, the growing emphasis on stock-based director compensation gives the board a direct financial interest in the firm's on-going success.[131] Fourth, director socialization inculcates effort and cooperation norms.[132] Finally, there is the self-esteem—the pride in doing a job well—which some theorists regard as the basis for norm compliance.[133] Taken together, these factors give directors strong incentives to minimize the firm's cost of capital.

Shareholders will view a director preference for other constituencies as a risk demanding compensatory returns.[134] First, absent the shareholder wealth maximization norm, the board would lack a determinate metric for assessing options. Because stakeholder decisionmaking models necessarily create a two masters problem,[135] such models inevitably lead to indeterminate results. Suppose that the board of directors is considering closing an obsolete plant. The closing will harm the plant's workers and the local community, but will benefit

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[129] KLEIN & COFFEE, *supra* note 24, at 44.

[130] *See supra* note 121 and accompanying text.

[131] *See supra* note 122 and accompanying text.

[132] *See* Bainbridge, *supra* note 52, at __ (discussing role of effort and cooperation norms in corporate governance).

[133] *See, e.g.*, Richard McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338 (1997) (positing that people value the esteem of others and that compliance with social norms earns one esteem, while violating such norms causes one to lose esteem).

[134] I am using the term "risk" here in its colloquial rather than its technical sense. In the strict sense in which the term is used in conventional finance lingo, director misconduct of the type described here does not create risk, because such misconduct does not affect the variation of returns. Instead, director misconduct erodes the expected shareholder return.

[135] *Cf.* MATTHEW 6:24 (stating: "No one can serve two masters.").

shareholders, creditors, employees at a more modern plant to which the work previously performed at the old plant is transferred, and communities around the modern plant. Assume that the latter groups cannot gain except at the former groups' expense. By what standard should the board make the decision? Shareholder wealth maximization provides a clear answer—close the plant. Once the directors are allowed to deviate from shareholder wealth maximization, however, they must inevitably turn to indeterminate balancing standards.

Such standards deprive directors of the critical ability to determine ex ante whether their behavior comports with the law's demands, raising the transaction costs of corporate governance.[136] The conflict of interest rules governing the legal profession provide a useful analogy. Despite many years of refinement, these rules are still widely viewed as inadequate, vague, and inconsistent—hardly the stuff of which certainty and predictability are made.[137]

Second, absent clear standards, directors will be tempted to pursue their own self-interest. One may celebrate the virtues of granting directors largely unfettered discretion to manage the business enterprise without having to ignore the agency costs associated with such discretion. Discretion should not be allowed to camouflage self-interest.

Directors who are responsible to everyone are accountable to no one. In the foregoing hypothetical, for example, if the board's interests favor keeping the plant open, we can expect the board to at least lean in that director. The plant likely will stay open, with the decision being justified by reference to the impact of a closing on the plant's workers and the local community. In contrast, if directors' interests are served by closing the plant, the plant will likely close, with the decision being justified by concern for the firm's shareholders, creditors, and other benefited constituencies.

At best, stakeholder models give directors a license to reallocate wealth from shareholders to nonshareholder constituencies. Would investors be willing to invest their retirement savings in corporate stock if that approach became law?

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[136] *Cf.* Harff v. Kerkorian, 324 A.2d 215, 220 (Del. Ch. 1974) (stating: "It is obviously important that the Delaware corporate law have stability and predictability.").

[137] *See* Nancy J. Moore, *Conflicts of Interest in the Simultaneous Representation of Multiple Clients: A Proposed Solution to the Current Confusion and Controversy,* 61 TEX. L. REV. 211 (1982); Marc I. Steinberg & Timothy U. Sharpe, *Attorney Conflicts of Interest: The Need for a Coherent Framework*, 66 NOTRE DAME L. REV. 1, 2 (1990).

Probably not.[138] An investment in corporate stock must bring shareholders a rate of return commensurate with the risks they are taking. If it does not, they will divest stock in favor of other investments or, at least, monitor directors more closely. In either case, the cost of equity capital will rise under stakeholder models.

To be sure, the business judgment rule (appropriately) insulates directors from liability despite the potential for conflicted interests.[139] The psychological effects of a switch to stakeholder models, however, should not be downplayed. Because the shareholder wealth maximization norm is central to director socialization, the norm provides a forceful reminder of where the director's loyalty lies.[140] Even if the business judgment rule renders its rhetoric largely unenforceable, the shareholder wealth maximization norm is an ever present goad. By removing the psychological constraint that the shareholder wealth maximization norm provides, and simultaneously exacerbating the two masters problem, we are less likely to encourage directors to pursue the collective interests of the firm's various constituents than to encourage directors to pursue their own self-interest.

The critical difference between the existing regime and the stakeholder models, moreover, emerges when we turn to those cases in which the business judgment rule does not apply with full force. Suppose, for example, that our hypothetical corporation receives a takeover bid from a bidder with a history of closing obsolete plants. The board rejects the bid, citing the bidder's history. All of the practical problems discussed above are present. More important, while an

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[138] Over the last several decades there has been a substantial increase in the number of Americans who own stock either directly or indirectly through mutual and pension funds. As the investor class has grown, the constituency for making trade-offs between investor and noninvestor interests may have shrunk. *Cf.* Hansmann and Kraakman, *supra* note 63, at 452 (noting that workers "increasingly share the economic interests of other equity-holders").

[139] *See* Bainbridge, *supra* note 56, at 976-80 (explaining how the business judgment rule insulates directors from liability in connection with operational decisions).

[140] *Cf.* Daniel P. Forbes and Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-making Groups*, 24 ACAD. MGMT. REV. 489, 493-94 (1999) (explaining how effort norms encourage board members to devote greater cognitive effort to their tasks instead of simply going through the motions).

honest concern for the threatened workers may have motivated the directors' decision, so too might a concern for their own positions and perquisites. A target board thus may use nonshareholder interests as nothing more than a negotiating device to extract side payments from the bidder. Under current law, the business judgment rule would not protect the directors' decision unless they could show that it also benefited the shareholders.[141] Because stakeholder models permit

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[141] *See* Bainbridge, *supra* note 56, at 980-84 (explaining how Delaware fiduciary duty law limits the discretion of directors to consider nonshareholder interests in the takeover setting). Blair and Stout contend that the conditional business judgment rule Delaware courts apply when reviewing an incumbent board of directors' resistance is consistent with their mediating hierarch model. *See* Blair & Stout, supra note 18, at 307-09 (discussing takeover decisions). To be sure, in Unocal Corp. vs. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985), the Delaware supreme court opined that directors may consider the impact of takeover decisions on nonshareholder constituencies. *Id.* at 955. The court later held, however, that directors may only consider stakeholder interests if doing so would benefit shareholders and, further, that directors may not do so at all once the corporation is "for sale." Revlon, Inc. v. MacAndrews & Forbes, Inc., 506 A.2d 173, 182 (Del. 1986). In my view, the conditional business judgment rule thus has teeth in the takeover setting. Bainbridge, *supra* note 56, at 984.

Blair and Stout also point to the nonshareholder constituency statutes adopted by many states, which authorize directors to consider nonshareholder interests in making corporate decisions. *See* Blair & Stout, supra note 18, at 303 n.144; *see also* Kent Greenfield & John E. Nilsson, *Gradgrind's Education: Using Dickens and Aristotle to Understand (and Replace?) the Business Judgment Rule*, 63 BROOKLYN L. REV. 799, 838-39 (1997) (arguing the nonshareholder constituency statute phenomenon calls into question the validity of the shareholder wealth maximization norm). Although Delaware has not done so, over half of the other states have adopted so-called nonshareholder constituency statutes, typically as part of a package of antitakeover laws, which expressly permit the board of directors to consider the effects of a corporate decision on nonshareholder interests. As I have argued elsewhere, however, these statutes do not reject the traditional shareholder wealth maximization norm. Instead, they modify the norm by allowing the board to make trade-offs between shareholder and stakeholder interests. Bainbridge, *supra* note 56, at 989-96. As such, the statutes work an unfortunate change in the basic normative principles underlying corporate law. *See* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green,* 50 WASH. & LEE. L. REV. 1423, 1423-24 n.2 (1993). Fortunately, courts seem to be ignoring these statutes and, at present, they appear to be little more than dust gathering relics of the 1980s wave of state antitakeover legislation. *See id.*

directors to play off one constituency against another, however, the accountability provided by current law would be lost.

As compensation for bearing these risks, shareholders will demand a higher return on their investment. Whatever value unfettered discretion has for directors would be outweighed by the costs associated with the increased risk of error and opportunism that would follow from adoption of any decisionmaking principle other than shareholder wealth maximization. Accordingly, when directors use the corporation as a vehicle for hiring equity capital, they would include that norm as one of the terms of the deal. Society therefore appropriately adopts the shareholder wealth maximization norm as a governing principle—it is the majoritarian default that emerges from the hypothetical bargain.

4. Another Perspective

Boards of directors sometimes face decisions in which it is possible to make at least one corporate constituent better off without leaving any constituency worse off. In economic terms, such a decision is Pareto efficient—it moves the firm from a Pareto inferior position to the Pareto frontier.[142] Other times, however, they face a decision that makes at least one constituency better off but leaves at least one worse off. Imagine a decision with a pay-off for one constituency of $150 that leaves another constituency worse off by $100. As a whole, the organization is better off by $50. In economic terms, this decision is Kaldor-Hicks efficient.[143] With this background in mind, the shareholder wealth maximization norm can be described as a bargained-for term of the board-

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(noting "dearth of cases"). The nonshareholder constituency statutes were just another example of special interest legislation adopted at the behest of union leaders and managers of target corporations to protect important local businesses from takeovers. Bainbridge, *supra* note 56, at 993.

[142] A Pareto superior transaction makes at least one person better off and no one worse off. *See generally* DAVID M. KREPS, A COURSE IN MICROECONOMIC THEORY 154-55 (describing Pareto efficiency).

[143] Kaldor-Hicks efficiency does not require that no one be made worse off by a reallocation of resources. Instead, it requires only that the resulting increase in wealth be sufficient to compensate the losers. Note that there does not need to be any actual compensation, compensation simply must be possible. ROBERT COOTER AND THOMAS ULEN, LAW AND ECONOMICS 41-42 (2d ed. 1997).

shareholder contract by which the directors agree not to make Kaldor-Hicks efficient decisions that leave shareholders worse off.

A commonly used justification for adopting Kaldor-Hicks efficiency as a decisionmaking norm is the claim that everything comes out in the wash.[144] With respect to one decision, I may be in the constituency that loses, but next time I will be in the constituency that gains. If the decisionmaking apparatus is systematically biased against a particular constituency, however, that justification fails. If shareholders suspect that their constituency would be systematically saddled with losses, they will insist on contract terms precluding directors from making Kaldor-Hicks decisions that leave shareholders worse off. As explained in the next section, shareholders in fact are the constituency most vulnerable to board misconduct and, by extension, to being on the losing end of Kaldor-Hicks efficient decisions. Hence, they predictably will bargain for something like the shareholder wealth maximization norm.

C. Quasi-rents and Fiduciary Duties

One of the chief tenets of contractarianism is that the law ought to facilitate private ordering. Hence, the preference of contractarians for default rules the parties are free to modify. So long as the default rule is properly chosen, most parties will be spared the need to reach a private agreement on the issue in question. Default rules in this sense provide cost savings comparable to those provided by standard form contracts, because both can be accepted without the need for costly negotiation. At the same time, however, because the default rule can be modified by contrary agreement, idiosyncratic parties wishing a different rule can be accommodated. Given these advantages, a fairly compelling case ought to be required before we impose a mandatory rule. Yet, the law should not always facilitate private ordering. Where there is a market failure, regulatory intervention may be appropriate.[145] Welfare economics classically recognizes

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[144] The validity of Kaldor-Hicks efficiency as a guide to public policy is sharply disputed. *See Richard A. Posner, The Economics of Justice* 91-94 (1981); Bruce Chapman, *Trust, Economic Rationality, and the Corporate Fiduciary Obligation,* 43 U. TORONTO L. REV. 547, 554-55 (1993).

[145] A basic premise of welfare economics is that a market failure is a necessary (but not sufficient) justification for government intervention. *Cf.* ROBERT COOTER AND THOMAS ULEN, LAW AND ECONOMICS 43-49 (1st ed. 1988) (setting forth basic aspects of

four basic sources of market failures: (1) producer monopoly; (2) public goods; (3) information asymmetries; and (4) externalities.[146] Of these, the latter is most pertinent for my purposes.

Corporate conduct doubtless generates negative externalities.[147] In appropriate cases, such externalities should be constrained through general welfare legislation, tort litigation, and other forms of regulation. Yet, it is easy to overstate the significance of those externalities. There is a notion abroad in the land, abetted by much of popular culture, that corporate managers and lawyers unwind from a hard day of nefarious skullduggery by torturing puppies. If the stereotype were true, it might justify an expansive approach to corporate social responsibility. Yet, there is no evidence that businessmen and women are any less ethical than, say, the Hollywood types who make such movies as *Erin Brockovich* or *A Civil Action*.[148] Why then should corporate law be concerned with the externalities of corporate conduct?

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welfare economics, including the notion that public policy can be used to correct market failures).

[146] *Id.* at 45.

[147] It is for this reason that one cannot justify the shareholder wealth maximization norm by claiming that a rising tide lifts all boats. In many cases, this will be true. Nonshareholder constituencies have a claim on the corporation that is both fixed and prior to that of the shareholders. So long as general welfare laws prohibit the corporation from imposing negative externalities on those constituencies, the shareholder wealth maximization norm redounds to their benefit. In some cases, however, the rising tide argument is inapplicable because it fails to take into account the question of risk. Pursuing shareholder wealth maximization often requires one to make risky decisions, which disadvantages nonshareholder constituencies. The increased return associated with an increase in risk does not benefit nonshareholders, because their claim is fixed, whereas the simultaneous increase in the corporation's riskiness makes it less likely that nonshareholder claims will be satisfied. Hence, the rising tide argument cannot be a complete explanation for the shareholder wealth maximization norm.

[148] *See* Robert H. Bork Jr., *Court Movies don't Mimic Life; Culture: Couldn't the Demands of Lively Entertainment Still Accommodate a More Balanced View of the System?,* L.A. TIMES, April 5. 2000, at B9 (arguing that such films create "a whole new mythology around avenging angels of the trial bar").

In the contractarian model, fiduciary duties are gap-fillers by which courts resolve disputes falling through the cracks of incomplete contracts.[149] More specifically, fiduciary duties prevent corporate directors and officers from appropriating quasi-rents through opportunistic conduct unanticipated when the firm was formed. Quasi-rents arise where investments in transaction specific assets create a surplus subject to expropriation by the contracting party with control over the assets.[150] A transaction specific asset is one whose value is appreciably lower in any other use than the transaction in question.[151] Once a transaction specific investment has been made, it generates quasi-rents—i.e., returns in excess of that necessary to maintain the asset in its current use.[152] If such quasi-rents are appropriable by the party with control of the transaction specific asset, a hold up problem ensues. Investments in transaction specific assets therefore commonly are protected through specialized governance structures created by detailed contracts. As we have seen, however, under conditions of uncertainty and complexity, bounded rationality precludes complete contracting.[153] Under such conditions, accordingly, fiduciary duties provide an alternative source of protection against opportunism.

The shareholder's investment in the firm is a transaction specific asset, because the whole of the investment is both at risk and turned over to someone else's control.[154] In contrast, many corporate constituencies do not make firm specific investments in either human capital or otherwise. Many corporate employees, for example, lack significant firm specific human capital.[155] For such

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[149] EASTERBROOK & FISCHEL, *supra* note 3, at 92.

[150] *See* Benjamin R. Klein et al., *Vertical Integration, Appropriable Rents and the Competitive Contracting Process*, 21 J. L. & ECON. 297 (1978).

[151] Hölmstrom & Roberts, *supra* note 66, at 74.

[152] *Id*. at 74 n.1. The asset may also generate true rents—i.e., returns exceeding that necessary to induce the investment in the first place—but the presence or absence of true rents is irrelevant to the opportunism problem. *See id*. (discussing true rents).

[153] *See supra* notes 36-37 and accompanying text.

[154] Williamson, *supra* note 78, at 1209.

[155] Stephen M. Bainbridge, *Corporate Decisionmaking and the Moral Rights of Employees: Participatory Management and Natural Law*, 43 VILLANOVA L. REV. 741, 817-18 (1998). The claim is not that nonshareholder constituencies do not invest in firm specific assets, such as firm specific human capital. In fact, many do so. *See infra* notes

employees, mobility may be a sufficient defense against opportunistic conduct, because they can quit and be replaced without productive loss to either employee or employer.[156] If the employee's general human capital suffices for him to do his job at Firm A, it presumably would suffice for him to do a similar job at Firm B. Such an employee resembles an independent contractor who can shift from firm to firm at low cost to either employee or employer.[157] Because the relationship between such employees and the corporation does not create appropriable quasi-rents, opportunism by the board is not a concern.

Consequently, shareholders are more vulnerable to director misconduct than are most nonshareholder constituencies. To be sure, some scholars assert that "when directors use their corporate position to steal money from the firm, every" constituency suffers.[158] Consider, however, a classic case of self-dealing. Assume a solvent corporation able to pay its debts and other obligations (especially employee salaries) as they come due in the ordinary course of business. Further assume that the corporation has substantial free cash flow—i.e., cash flows in excess of the positive net present value investments available to the corporation. If the directors siphon some portion of the corporation's free cash flow into their own pockets, shareholders are clearly hurt, because the value of the residual claim has been impaired. Yet, in this case, there is no readily apparent injury to the value of the fixed claim of all other corporate constituents.

For the sake of argument, however, I assume herein that appropriation of quasi-rents is an equally severe problem for both shareholders and nonshareholder constituencies. Many employees do invest in firm specific human capital.[159]

159-160 and accompanying text. My point is only to remind the reader that many nonshareholder constituencies do not.

[156] Williamson, *supra* note 78, at 1207.

[157] This is not to say that exit is costless for either employees or firms. All employees are partially locked into their firm. Indeed, it must be so, or monitoring could not prevent shirking because disciplinary efforts would have no teeth. The question is one of relative costs.

[158] Blair & Stout, *supra* note 18, at 299.

[159] Roberta Romano, *Corporate Law and Corporate Governance*, 5 INDUSTRIAL & CORP. CHANGE 277, 280 (1996).

Creditors may also develop firm specific expertise, particularly in long-term relationships with a significant number of repeat transactions.[160]

Relative to many nonshareholder constituencies, shareholders are poorly positioned to extract contractual protections.[161] Unlike bondholders, for example, whose term-limited relationship to the firm is subject to extensive negotiations and detailed contracts, shareholders have an indefinite relationship that is rarely the product of detailed negotiations. The dispersed nature of stockownership, moreover, makes bilateral negotiation of specialized safeguards especially difficult:

> Arrangements among a corporation, the underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented. The rights and obligations of the various parties are or should be spelled out in that documentation. The terms of the contractual relationship agreed to and not broad concepts such as fairness [therefore] define the corporation's obligation to its bondholders.[162]

Put another way, bond indentures necessarily are incomplete.[163] Even so, they still provide bondholders with far greater contractual protections than shareholders receive from the corporate contract as represented by the firm's

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[160] *Id.*

[161] The analysis herein applies mainly to voluntary constituencies of the firm, although the political process point is not wholly inapt with respect to involuntary constituencies. In any case, corporate law is an exceptionally blunt instrument with which to protect involuntary constituencies (and voluntary constituencies, as well, for that matter). Tort, contract, and property law, as well as a host of general welfare laws, provide them with a panoply of protections. *See generally* Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991).

[162] Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986).

[163] *See* Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 234 (1999) (stating that "[a]ll contracts have gaps"). The claim here is simply that the shareholder-corporation contract is especially "gappy." The ownership-like rights conferred by the shareholder's contract follow from this phenomenon. *Cf.* George P. Baker and Thomas N. Hubbard, *Empirical Strategies in Contract Economics: Information and the Boundary of the Firm*, AEA PAPERS & PROCEEDINGS, May 2001, at 189, 192 (finding that technological developments promoting contractability within the trucking industry led to vertical integration).

organic documents.[164] Accordingly, we can confidently predict the majoritarian default that would emerge from the hypothetical bargain. Shareholders will want the protections provided by fiduciary duties, while bondholders will be satisfied with the ability to enforce their contractual rights, which is precisely what the law provides.[165]

Like bondholders, employees regularly bargain with employers both individually and collectively.[166] So do other stakeholders, such as local communities that bargain with existing or prospective employers, offering firms tax abatements and other inducements in return for which they could and should extract promises about the firm's conduct. In general, the interests of such constituents lend themselves to more concrete specification then do the open-ended claims of shareholders.[167] Those nonshareholder constituencies that enter voluntary relationships with the corporation thus can protect themselves by adjusting the contract price to account for negative externalities imposed upon them by the firm.

Granted, the extent of negotiations between the corporation and nonshareholders is likely to vary widely. In many cases, such as hiring shop floor employees, the only negotiation will be a take it-or-leave it offer. But so what? Is

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[164] Unlike secured creditors or employees with firm specific human capital, the shareholder's transaction specific investment is not associated with particular assets. Romano, supra note 159, at 279. Also unlike other corporate constituents, shareholders have no right to periodic renegotiation of the firm's of their relationship with the firm. As a result, the shareholders' interest in the firm is more vulnerable to both uncertainty and opportunism than are those of other corporate constituents. Unlike those corporate constituents whose interests are adequately protected by contract, shareholders therefore require special protection. Hence, both the shareholder right to elect directors and the fiduciary obligation of those directors to maximize shareholder wealth. *See id.*

[165] *See, e.g.,* Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986) (holding that "the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature"); *see also* Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1524-25 (S.D.N.Y. 1989); Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988); Revlon, Inc. v. MacAndrews & Forbes, Inc., 506 A.2d 173, 182 (Del. 1986).

[166] For a more elaborate argument that employee interests are adequately protected by contract and general welfare legislation, see Bainbridge, *supra* note 41, at 1070-75.

[167] Romano, supra note 159, at 280.

a standard form contract any less of a contract just because it is offered on a take it-or-leave it basis? If the market is competitive, a party making a take it-or-leave it offer must set price and other terms that will lead to sales despite the absence of particularized negotiations. As long as the firm must attract inputs from nonshareholder constituencies in competitive markets, the firm similarly will have to offer those constituencies terms that compensate them for the risks they bear.

This point persistently eludes proponents of the stakeholder model, who ask: "Can it really be said that employees (or local communities or dependent suppliers) are really better able to negotiate the terms of their relationship to the corporation than are shareholders?"[168] While they presumably intend this to be a purely rhetorical question, it has an answer—an affirmative one.

As we have seen, shareholders have no meaningful voice in corporate decisionmaking.[169] In effect, shareholders have but a single mechanism by which they can "negotiate" with the board: withholding capital. If shareholder interests are inadequately protected, they can refuse to invest. The nexus of contracts model, however, demonstrates that equity capital is but one of the inputs that a firm needs to succeed. Nonshareholder corporate constituencies can thus "negotiate" with the board in precisely the same fashion as do shareholders: by withholding their inputs. If the firm disregards employee interests, it will have greater difficulty finding workers. Similarly, if the firm disregards creditor interests, it will have greater difficulty attracting debt financing, and so on.

In fact, withholding one's inputs may often be a more effective tool for nonshareholder constituencies than it is for shareholders. Some firms go for years without seeking equity investments. If these firms' boards disregard shareholder interests, shareholders have little recourse other than to sell out at prices that will reflect the board's lack of concern for shareholder wealth. In contrast, few firms can survive for long without regular infusions of new employees and new debt financing. As a result, few boards can prosper for long while ignoring nonshareholder interests.

Let us assume, however, that nonshareholder constituencies are unable to protect themselves through contract. The right rule would still be director

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[168] Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1418 (1993).

[169] *See supra* notes 88-102 and accompanying text.

fiduciary duties incorporating the shareholder wealth maximization norm. Many nonshareholder constituencies have substantial power to protect themselves through the political process.[170] Public choice theory teaches that well-defined interest groups are able to benefit themselves at the expense of larger, loosely defined groups by extracting legal rules from lawmakers that appear to be general welfare laws but in fact redound mainly to the interest group's advantage. Absent a few self-appointed spokesmen, most of whom are either gadflies or promoting some service they sell, shareholders—especially individuals—have no meaningful political voice. In contrast, many nonshareholder constituencies are represented by cohesive, politically powerful interest groups. Consider the enormous political power wielded by unions, who played a major role in passing state anti-takeover laws.[171] Because those laws temporarily helped kill off hostile takeovers, the unions helped kill the goose that laid golden eggs for shareholders.[172] From the unions' perspective, however, hostile takeovers were inflicting considerable harm on workers. The unions were probably wrong on that score, but the point is that the unions used their political power to transfer wealth from shareholders to nonshareholder constituencies.

Collective bargaining obviously does not protect nonunionized workers, but such protections are nevertheless provided by both legal and market forces. Various market mechanisms have evolved to protect employee investments in firm specific human capital, such as ports of entry, seniority systems, and promotion ladders. As private sector unions have declined, moreover, the federal government has intervened to provide through general welfare legislation many of the same protections for which unions might have bargained. The Family &

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[170] Where the board has been captured by senior management, nonshareholders also are indirectly protected because management's interests are more likely to be aligned with those of nonshareholder constituencies than with those of the shareholders. Salaried managers hold what amounts to a fixed claim on the corporation's assets and earnings, which is not too dissimilar from the claims of other nonshareholder constituencies. Moreover, much of corporate managers' wealth is tied up in nondiversified firm specific human capital. These factors tend to make them more concerned with ensuring the firm's survival than with taking risks that would maximize shareholder wealth.

[171] Bainbridge, supra note 56, at 1009 n.154.

[172] The evidence is overwhelming that shareholders reap substantial gains from takeovers. *See id.* at 1009-10 (summarizing studies).

Medical Leave Act grants unpaid leave for medical and other family problems.[173] The Occupational Safety & Health Administration (OSHA) mandates safe working conditions.[174] Plant closing laws require notice of layoffs.[175] Civil rights laws protect against discrimination of various sorts.[176] And so on.

Such targeted legislative approaches are a preferable solution to the externalities created by corporate conduct. General welfare laws designed to deter corporate conduct through criminal and civil sanctions imposed on the corporation, its directors, and its senior officers are more efficient than stakeholderist tweaking of director fiduciary duties. By virtue of their inherent ambiguity, fiduciary duties are a blunt instrument. There can be no assurance that specific social ills will be addressed by the boards of the specific corporations that are creating the problematic externalities.[177]

D. Summation

In the director primacy model, the board negotiates contracts with various factors of production. The various inputs have distinct needs, but also distinct comparative advantages with respect to possible schemes of extra-judicial governance schema. Hence, for example, banks have great expertise in monitoring, so it makes sense that they have detailed contractual control rights triggered by financial defaults. To be sure, neither the contracting nor the

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[173] 28 U.S.C. § 2612 (2001).

[174] 29 U.S.C. § 651 (2001).

[175] 29 U.S.C. §§ 2101(b)(1), 2102 (2001).

[176] *See, e.g.,* 42 U.S.C. § 2000e-2 (2001) (prohibiting employment discrimination on the basis of race, color, sex, or national origin); id. § 2000e-3 (prohibiting employment discrimination for the bringing of charges, testifying or other participation in law enforcement proceedings or for employer publication or advertisement of a preference for employees of a specific race, color, religion, sex, or national origin).

[177] Targeted legislation becomes even more attractive when one realizes that consideration of nonshareholder interests is a task for which corporate directors are poorly suited. The shareholder wealth maximization principle dominates both legal and managerial thinking about fiduciary duties. Given the socialization and training of modern U.S. corporate managers, shareholder wealth maximization is the norm most likely to prevail in any consensus-building process.

political process is perfect, but each standing alone probably provides nonshareholder constituencies with more meaningful protections than would the stakeholder model of corporate law.

IV. THE ENDS AXIS (PART II): MEDIATING HIERARCHS OR SHAREHOLDER WEALTH MAXIMIZERS?

The distinction between my director primacy model and the team production model manifests itself along the ends axis of Figure 1. Blair and Stout contend that corporate law treats directors not as hierarchs charged with serving shareholder interests, but as referees—mediating hierarchs, to use their term—charged with serving the interests of the legal entity known as the corporation.[178] In turn, the corporation's interests are defined as the "joint welfare function" of all constituents who make firm specific investments.[179] Although Blair and Stout

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[178] Blair & Stout, *supra* note 18, at 288. The mediating hierarch model resembles Lynne Dallas' theory of the relational board, which "assist[s] the corporation in forging relationships with various stakeholders and others in its social environment." Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. CORP. L. 1, 3 (1996). It also resembles Larry Mitchell's proposal to "to recast the board of directors as a mediating body among the different corporate constituent groups." Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263, 1272 (1992).

[179] Blair & Stout, *supra* note 18, at 288. This aspect of Blair and Stout's argument is similar to the claim advanced by Thomas Smith in a provocative recent article. Smith contends that the correct governing norm for corporate decisionmaking is one obliging the board to maximize the value all the financial claims the corporation has issued. Smith, *supra* note 163, at 217-18. Smith's argument is based in the first instance on an assumption that investors (and, presumably, managers) are rational. *Id*. at 239-42. To the extent one assumes rationality is bounded, however, a simpler norm—maximize share value rather than the aggregate value of all financial claims—may be desirable. *Cf.* Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty),* 53 BUS. LAW. 429 (1998) (arguing that corporate fiduciary duties should not be defined by the reference to rational diversified investors, in part because managers cannot know what policies such investors would prefer). In any case, Smith assumes that rational investors invest across a wide array of assets and therefore would prefer a rule requiring that "managers should make the choice that will maximize the value of rational investors' diversified portfolios." Smith, *supra* note 163, at 242. Yet, to the extent we have evidence as to the preferences of actual investors, those

tend to downplay the normative implications of their model, they acknowledge that it "resonates" with the views of progressive corporate legal scholarship.[180] They differ from the progressive wing of the corporate law academy mainly on positive grounds. Many progressives believe that corporate directors currently do not take sufficient account of nonshareholder constituency interests and that law reform is necessary.[181] In contrast, Blair and Stout believe that corporate directors do take such interests into account and the current law is adequate in this regard.[182]

A. The Firm as Team

Team production is an important and highly useful concept in neoinstitutional economics. Blair and Stout stretch the team production model to encompass the entire firm.[183] Doing so is unconventional. In my view, stretching team production that far also detracts from the model's utility.

Production teams are defined conventionally as "a collection of individuals who are interdependent in their tasks, who share responsibility for outcomes,

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investors appear to prefer a rule of share value maximization. The Council of Institutional Investor's corporate governance policy states, for example, calls for "governance structures and practices" that "protect and enhance accountability to, and equal financial treatment of, *shareholders*. An action should not be taken if its purpose is to reduce accountability to *shareholders*." Council of Institutional Investors, Corporate Governance Policies, at http://www.cii.org/corp_ governance.htm (emphasis supplied). Similarly, Lens Investment Management LLC's policy statement refers to its desire to "to maximize *shareholder* values." Lens Investment Management LLC, Statement of Policy, at http://www.lens-inc.com/lenspolicy.html (emphasis supplied). Finally, Smith does not resolve the two masters problem. In other words, when managers are confronted with a zero-sum situation requiring them to make trade-offs between various claims, which claim do they prefer? *Cf.* Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986) (holding that a corporation's board is obliged to maximize shareholder interests, even if doing so is adverse to the interests of debenture holders).

[180] Blair & Stout, *supra* note 18, at 286.

[181] *Id.* at 286 n.83.

[182] *See id.* at 286 nn.82-83 (discussing nonshareholder constituency literature).

[183] *See id.* at 269 (stating: "we argue that shareholders, executives, and employees are *all* team members"; emphasis in the original).

[and] who see themselves and who are seen by others as an intact social entity embedded in one or more larger social systems ...."[184] This definition contemplates that production teams are embedded within a larger entity. As one commentator defines them, teams are "intact social systems that perform one or more tasks within an organizational context."[185]

Building on the work of Rajan and Zingales, Blair and Stout define team production by reference to firm specific investments.[186] Hence, for example, they describe the firm "as a 'nexus of firm-specific investments.'"[187] In fact, however, firm specific investments are not the defining characteristic of team production. Instead, the common feature of team production is task nonseparability.

Oliver Williamson identifies two forms production teams take: primitive and relational. In both, team members perform nonseparable tasks. The two forms are distinguished by the degree of firm specific human capital possessed by such members. In primitive teams, workers have little such capital; in relational teams, they have substantial amounts.[188] Because both primitive and relational team production requires task nonseparability, it is that characteristic that defines team production.

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[184] Susan G. Cohen and Diane E. Bailey, *What Makes Teams Work: Group Effectiveness Research from the Shop Floor to the Executive Suite*, 23 J. MGMT. 239, 241 (1997).

[185] Kenneth L. Bettenhausen, *Five Years of Groups Research: What have we Learned and What Needs to be Addressed?,* 17 J. MGMT. 345, 346 (1991)

[186] *See id*. at 271-73 (discussing Raghuram G. Rajan & Luigi Zingales, *Power in the Theory of the Firm*, 113 Q. J. ECON. 387 (1998)). Of course, many corporate constituents invest little in firm specific capital (human or otherwise), but this is mere quibbling. *See supra* text accompanying note 155. Conversely, David Millon criticizes Blair and Stout on the ground that shareholders are the corporate constituency least likely to make firm specific investments. David Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001, 1007 n.15 (2000). In my view, Millon's position both overstates the extent to which nonshareholder constituencies make firm specific investments and understates the extent to which shareholders do so. *See supra* notes 154-160 and accompanying text (discussing relative investments in firm specific assets by corporate constituencies).

[187] Blair & Stout, *supra* note 18, at 275.

[188] *See* WILLIAMSON, *supra* note 35, at 244-47 (discussing team production as a function of task separability and asset specificity).

Most public corporations have both relational and primitive teams embedded throughout their organizational hierarchy. Self-directed work teams, for example, have become a common feature of manufacturing shop floors and even some service workplaces.[189] Even the board of directors can be regarded as a relational team.[190] Hence, the modern public corporation arguably is better described as a hierarchy of teams rather than one of autonomous individuals. To call the entire firm a team, however, is neither accurate nor helpful.

As among shop floor workers organized into a self-directed work team, for example, team production is an appropriate model precisely because their collective output is not task separable.[191] In a large firm, however, the vast majority of tasks performed by the firm's various constituencies are task separable. The contribution of employees of one division versus those of a second division can be separated. The contributions of employees and creditors can be separated. The contributions of supervisory employees can be separated from those of shop floor employees. And so on.[192] Accordingly, the concept of

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[189] *See* Bainbridge, *supra* note 41, at 1018-20 (describing self-directed work teams).

[190] *See* Bainbridge, *supra* note 52, at ___.

[191] *See* Bainbridge, *supra* note 41, at 1042-44 (applying Williamson's analysis to production teams).

[192] The canonical example of task nonseparability in a team production setting was developed by Alchian and Demsetz, who hypothesized two workers jointly lifting heavy boxes into a truck. The marginal productivity of each worker is very difficult to measure and their joint output cannot be easily separated into individual components. In such situations, obtaining information about a team member's productivity and appropriately rewarding each team member are very difficult and costly. In the absence of such information, however, the disutility of labor gives each team member an incentive to shirk because the individual's reward is unlikely to be closely related to conscientiousness. Hence, the need for monitoring. Alchian & Demsetz, supra note 39, at 779-80. In order for an activity to be task nonseparable, it must be impossible (or very costly) to measure individual marginal productivity. *See* WILLIAMSON, *supra* note 35, at 244. Is it useful to think of shareholders and creditors as part of a production team? If so, is it impossible to measure their marginal contributions to firm productivity? Firms can readily determine their respective equity and debt costs of capital, which seems a reasonable proxy for measuring the value of (and thus the contribution of) financial inputs. *Cf*. RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE GOVERNANCE 543-46 (6th ed.2000) (discussing calculation of the weighted average cost of capital). The effort firms devote to tweaking their capital

team production is simply inapt with respect to the large public corporations with which Blair and Stout are concerned.[193]

B. The Domain of the Mediating Hierarchy

John Coates argues that Blair and Stout's mediating hierarch model fares poorly whenever there is a dominant shareholder.[194] If so, the model's utility is vitiated with respect to close corporations, wholly-owned subsidiaries, and publicly held corporations with a controlling shareholder. In addition, Coates argues, Blair and Stout's model also fares poorly whenever any corporate constituent dominates the firm.[195] Many of publicly held corporations lacking a controlling shareholder are dominated one of the constituents among which the board supposedly mediates—namely, top management. Although the precise figures disputed, a substantial minority of publicly held corporations have boards in which insiders comprise a majority of the members.[196] Even where a majority of the board is nominally independent, the board may be captured by insiders.[197]

I more skeptical than Coates of board capture theories, having argued elsewhere that independent board members have substantial incentives to buck management.[198] On balance, however, Coates makes a persuasive case that the

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structure when making financing decisions also suggests an ability to separate the relative contributions of creditors and equity investors. *Cf. id.* at 528 (concluding that "capital structure matters").

[193] The objection is important, although not fatal to Blair and Stout's project. In my view, they could defend the mediating hierarch model without using team production concepts at all. Instead, as I see it, the team production model serves them largely as a rhetorical device to establish a favorable setting in which the mediating hierarch concept seemingly follows as a matter of course.

[194] *See* Coates, *supra* note 96, at 840-42 (discussing ways the mediating hierarch model fails to explain such firms).

[195] *Id*. at 843.

[196] *Id.* at 844-45.

[197] *Id*. at 845-46.

[198] *See supra* note 59 and accompanying text (describing argument).

mediating hierarch model has a relatively small domain.[199] In contrast, the domain of director primacy, which merely requires the absence of a controlling shareholder, seems considerably larger.

C. The Foundational Hypothetical

Blair and Stout develop the mediating hierarchy model by telling the story of a start-up venture in which a number of individuals come together to undertake a team production project.[200] The participating constituents know that incorporation, especially the selection of independent board members, will reduce their control over the firm and, consequently, expose their interests to shirking or self-dealing by other participants.[201] They go forward, Blair and Stout suggest, because the participants know the board of directors will function as a mediating hierarch resolving horizontal disputes among team members about the allocation of the return on their production.[202]

On its face, Blair and Stout's scenario is not about established public corporations. Instead, their scenario seems heavily influenced by the high-tech start-ups of the late 1990s.[203] Yet, even in that setting, the model seems inapt. In

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[199] In a forthcoming article, Blair and Stout retort that the domain may be small when measured by number of firms, but not when measured by the asset value of those firms. Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, __ WASH. U.L.Q. ___ (2001).

[200] *See* Blair & Stout, *supra* note 18, at 275-76.

[201] *Id*. at 277.

[202] *See id*. at 278 (arguing that "shareholders, employees, and perhaps other stakeholders such as creditors or the local community ... enter into this mutual agreement in an effort to reduce wasteful shirking and rent-seeking by relegating to the internal hierarchy the right to determine the division of duties and resources in the joint enterprise."). Blair and Stout's model assumes that "the likely economic losses to a productive team from unconstrained shirking and rent-seeking are great enough to outweigh the likely economic losses from turning over decisionmaking power to a less-than-perfectly-faithful hierarch." Id. at 284. As yet, however, we lack empirical evidence that corporate constituents make such trade-offs and, if so, that the trade-off leans in the predicted direction.

[203] Given the vast media attention devoted to start-ups during the late 1990s, they admittedly made a seductive target for scholarly inquiry. *See, e.g.,* Gulati et al., *supra*

the typical pattern, the entrepreneurial founders hire the first factors of production.[204] If the firm subsequently goes public,[205] the founding entrepreneurs commonly are replaced by a more or less independent board.[206] The board thus displaces the original promoters as the central party with whom all other corporate constituencies contract. It is due to my empirical impression that this is the typical pattern that director primacy assumes the board of directors—whether comprised of the founding entrepreneurs or subsequently appointed outsiders—hires factors of production, not the other way around.[207]

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note 24, at 896-97 (discussing Internet start-ups and virtual firms). Query, however, whether such firms tell us much about the governance of established public corporations. Ironically, the paradigmatic late 1990s start-up—dot-com firms—had notoriously severe corporate governance problems, which may been a contributing factor in their recent economic problems. *See, e.g.*, Peter Buxbaum, *The Trouble with Dot-Com Boards*, CHIEF EXECUTIVE, Oct. 1, 2000, at 50.

[204] Equity capital may be the principal exception. In many respects, it is more accurate to say that venture capitalists hire entrepreneurs than vice-versa. At the very least, the two must collaborate closely. *See* Daniel M. Cable & Scott Shane, *A Prisoner's Dilemma Approach to Entrepreneur-Venture Capitalist Relationships*, 22 ACAD. MGMT. REV. 142 (1997); D. Gordon Smith, *Team Production in Venture Capital Investing*, 24 J. CORP. L. 949, 960 (1999).

[205] Blair and Stout suggest that the decision of such promoters to subsequently go public "may be driven in part by team production considerations." Blair & Stout, *supra* note 18, at 281. It seems more likely that the decision to go public is driven either by a need for additional equity financing or, even more likely, by the desire to cash out some portion of the founder's stock (i.e., to get rich). *See generally* Richard A. Booth, *The Limited Liability Company and the Search For a Bright Line Between Corporations and Partnerships*, 32 WAKE FOREST L. REV. 79, 89-92 (1977) (evaluating motives for going public).

[206] *See* Sam Allgood & Kathleen A. Farrell, *The Effect of CEO Tenure on the Relation Between Firm Performance and Turnover*, 23 J. FIN. RES. 373 (2000) (reporting "it appears founders are initially entrenched, but lose control of their board of directors later in their tenure").

[207] This empirical claim is consistent with the legal architecture of corporate formation. As envisioned by the statute, the corporation is formed by incorporators. MODEL BUS CORP. ACT ANN. § 2.01 (1997). The corporation comes into existence when the articles of incorporation are accepted by the Secretary of State. *Id.* § 2.03(a). If the initial directors are named in the articles, they are required to hold an organizational

Lest the foregoing seem like an argument for shareholder primacy, I think it is instructive to note the corporation—unlike partnerships, for example—did not evolve from enterprises in which the owners of the residual claim managed the business. Instead, as a legal construct, the modern corporation evolved out of such antecedent forms as municipal and ecclesiastical corporations.[208] The board of directors as an institution thus pre-dates the rise of shareholder capitalism.[209] When the earliest industrial corporations began, moreover, they typically were large enterprises requiring centralized management.[210] Hence, separation of ownership and control was not a late development but rather a key institutional characteristic of the corporate form from its inception.[211] At the risk of descending into chicken-and-egg pedantry, the historical record thus suggests that director primacy emerged long before shareholder primacy. Directors have always hired factors of production, not vice-versa.

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meeting at which, *inter alia*, officers are named. *Id.* § 2.05(a)(1). If not, the incorporators conduct the organizational meeting. *Id*. § 2.05(a)(2). Instructively, the statutory scheme thus contemplates that the board of directors pre-dates other corporate constituencies. In practice, of course, promoters will make contracts with many factors of production before the corporation is formed. *See id.* § 2.04 (imposing joint and several liability on promoters for preincorporation contracts).

[208] *See* II JOHN P. DAVIS, CORPORATIONS: A STUDY OF THE ORIGIN AND DEVELOPMENT OF GREAT BUSINESS CORPORATIONS AND OF THEIR RELATION TO THE AUTHORITY OF THE STATE 217 (1905) (stating: "In the beginning the germ of the future conception of a corporation made its way into the English law through the recognition of the 'communities' of cities and towns, and of the body of rights and duties appertaining to residence in them."); *see also id.* at 222 (noting the contributions of ecclesiastical corporations and guilds to the evolving corporate form).

[209] *Cf.* RONALD E. SEAVOY, THE ORIGINS OF THE AMERICAN BUSINESS CORPORATION: 1784-1855 10 (1982) (discussing the emergence and role of the board of trustees of colonial ecclesiastical corporations).

[210] *Id.* at 4-5.

[211] *See* Walter Werner, *Corporation Law in Search of its Future*, 81 COLUM. L. REV. 1611, 1629-44 (1981) (discussing the separation of ownership and control in historical context).

D. The Board's Role

In Blair and Stout's model, directors are hired by all constituencies and charged with balancing the competing interests of all team members "in a fashion that keeps everyone happy enough that the productive coalitions stays together."[212] In other words, the principal function of the mediating board is resolving disputes among other corporate constituents.[213] This account of the board's role differs significantly from the standard account.

The literature typically identifies three functions performed by boards of public corporations:[214] First, and foremost, the board monitors and disciplines top management. Second, while boards rarely are involved in day-to-day operational decisionmaking, most boards have at least some managerial functions. Broad policymaking is commonly a board prerogative, for example. Even more commonly, however, individual board members provide advice and guidance to top managers with respect to operational and/or policy decisions. Finally, the board provides access to a network of contacts that may be useful in gathering resources and/or obtaining business. Outside directors affiliated with financial institutions, for example, apparently facilitate the firm's access to capital.[215] In none of these capacities, however, does the board of directors directly referee between corporate constituencies.

To be sure, institutional economics acknowledges that dispute resolution is an important function of any governance system.[216] Ex post gap-filling and error correction are necessitated by the incomplete contracts inherent in corporate governance. Those functions inevitably entail dispute resolution. As we've seen, the firm addresses the problem of incomplete contracting by creating a central

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[212] Blair & Stout, *supra* note 18, at 281.

[213] *See id.* at 284 (comparing directors to "the referee in a the football game").

[214] The following tracks the taxonomy suggested by Johnson et al., who map "directors responsibilities into three broadly defined roles ... labeled control, service, and resource dependence." Jonathan L. Johnson et al., *Boards of Directors: A Review and Research Agenda*, 22 J. MGMT. 409, 411 (1996).

[215] *Id.* at 428 (summarizing studies).

[216] *See* WILLIAMSON, *supra* note 67, at 176-77 (discussing the organizational concerns of transaction cost economics).

decisionmaker authorized to rewrite by fiat the implicit—and, in some cases, even the explicit—contracts of which the corporation is a nexus.

As the principal governance mechanism within the public corporation, the board of directors is that central decisionmaker and, accordingly, bears principal dispute resolution responsibility. Yet, in doing so, the board "is an instrument of the residual claimants."[217] Hence, if the board considers the interests of nonshareholder constituencies when making decisions, it does so only because shareholder wealth will be maximized in the long-run.[218]

If directors suddenly began behaving as mediating hierarchs, rather than shareholder wealth maximizers, an adaptive response would be called forth.[219] Consistent with the predictions developed above,[220] shareholders would adjust their relationships with the firm, demanding a higher return to compensate them for the increase in risk to the value of their residual claim resulting from director freedom to make trade-offs between shareholder wealth and nonshareholder

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[217] *Id.* at 175.

[218] *See supra* notes 135-141 and accompanying text (discussing how board incentives are aligned with shareholder interests). Blair and Stout posit that the legal mechanisms purporting to ensure director accountability to shareholder interests—such as derivative litigation and voting rights—benefit all corporate constituents. Blair & Stout, *supra* note 18, at 289. *See also id*. at 313 (asserting that shareholders' self-interested exercise of voting rights can "serve the interest of other stakeholders in the firm as well"). Conceding that shareholder and nonshareholder interests are often congruent, it nevertheless remains the case that some situations present zero-sum games. Further conceding the weakness of those accountability mechanisms, shareholder standing to pursue litigation and/or the exercise of shareholder voting rights nevertheless give shareholders rights that potentially can be used to the disadvantage of other constituencies.

[219] Director motivation is a question that plagues all three models of the board. Under shareholder primacy, why would directors accept a role in which they expend effort to maximize the wealth of others? Under the mediating hierarch approach, why would directors be willing to serve as referees? Under director primacy, why would directors want to hire factors of production and exercise fiat? If the directors are the residual claimants, of course, the answer is obvious—they are motivated by self-interest in the value of their claim. Once ownership of the residual claim is separated from decisionmaking power, however, we require a more robust theory of director motive.

[220] *See supra* notes 135-141 and accompanying text.

constituency interests. Ironically, this adaptation would raise the cost of capital and thus injure the interests of all corporate constituents whose claims vary in value with the fortunes of the firm.

E. A Doctrinal Test: The Business Judgment Rule

Because a model's ability to predict real world outcomes is more important than the extent to which the model's assumptions accurately depict the real world,[221] the key question is whether the mediating hierarchy model facilitates accurate predictions about the content of the law. To support their claim that the mediating hierarch model explains the substantive content of corporate law as it exists today, Blair and Stout examine a substantial number of doctrinal principles.[222] Out of consideration for the long-suffering reader, because delving deeply may be more instructive than taking a broad overview, and so as to leave something for future articles, I focus here on a single doctrine—the business judgment rule.

The business judgment rule is the separation of ownership and control's chief common law corollary.[223] It pervades every aspect of the state law of corporate

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[221] *See* Milton Friedman, *The Methodology of Positive Economics*, in ESSAYS IN POSITIVE ECONOMICS 23, 27 (1985).

[222] For a more extensive analysis of Blair and Stout's doctrinal claims, see Millon, supra note 186, at 1009-20.

[223] *See infra* text accompanying note 229 (quoting Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985)). Two conceptions of the business judgment rule compete in the case law. One treats the rule as having substantive content. In this version, the business judgment rule comes into play only after one has first determined that the directors satisfied some standard of conduct. *See, e.g.,* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) (holding that plaintiffs rebut the business judgment rule's presumption of good faith by "providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty or due care"). Alternatively, the business judgment rule is seen as an abstention doctrine. Under this version, the court will abstain from reviewing the substantive merits of the directors' conduct unless the plaintiff can rebut the business judgment rule's presumption of good faith. *See, e.g.,* Shlensky v. Wrigley, 237 N.E.2d 776, 779 (Ill. App. 1968) (holding that: "In a purely business corporation ... the authority of the directors in the conduct of the business of the corporation must be regarded as absolute when they act

governance, from allegedly negligent decisions by directors, to self-dealing transactions, to board decisions to seek dismissal of shareholder litigation, and so on.[224] Enabling one to make accurate predictions about the business judgment rule's scope and content thus stands as the basic test for any model.

Blair and Stout correctly assert that the business judgment rule does not reflect a norm of shareholder primacy, but err in suggesting that the business judgment rule does not reflect a norm of shareholder wealth maximization.[225] The case law, properly understood, does not stand for the proposition that directors have discretion to make trade-offs between nonshareholder and shareholder interests.[226] Instead, the cases stand for the proposition that courts will abstain from reviewing the exercise of directorial discretion even when the complainant alleges that directors took nonshareholder interests into account in making their decision.[227]

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within the law, and the court is without authority to substitute its judgment for that of the directors."). Explaining the doctrinal and policy superiority of the latter conception is one of those tasks best left for another day.

[224] *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (fiduciary duties of controlling shareholder); Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. 1968) (operational decision); Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979) (dismissal of derivative litigation).

[225] *See* Blair & Stout, *supra* note 18, at 303 (arguing that the business judgment rule authorizes directors to make trade-offs between shareholder and nonshareholder interests); *see also* Greenfield and Nilsson, *supra* note 141, at 831 (arguing that the business judgment rule reflects "an underlying distrust of the strict fiduciary duty to maximize shareholder returns"); Smith, *supra* note 113, at 286-87 (arguing that the business judgment rule precludes liability where directors fail to maximize shareholder wealth).

[226] For a concise critique of each of the business judgment rule-based opinions on which Blair and Stout relied, see Millon, *supra* note 186, at 1015-16 n.40.

[227] A few cases can be read to suggest that directors need not treat shareholder wealth maximization as their sole normative objective. Upon close examination, however, most of these cases in fact are not inconsistent with the shareholder wealth maximization norm. *See supra* 56 (discussing such cases). In Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. 1968), for example, a minority shareholder in the Chicago Cubs sued Wrigley, the team's majority shareholder, over the latter's famous refusal to install lights at Wrigley Field. Shlensky claimed the decision against lights was motivated by Wrigley's beliefs that baseball was a day-time sport and that night baseball might have a

The question is one of means and ends. In the classic case of *Dodge v. Ford Motor Co*., the court emphasized that director discretion is the means by which corporations are governed.[228] More recently, the Delaware supreme court explained:

> Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in [Delaware General Corporation Law] § 141(a), the business and affairs of a Delaware corporation are managed by or under its board of directors.... The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors.[229]

In other words, the rule ensures that the null hypothesis is deference to the board's authority as the corporation's central and final decisionmaker.[230] On this Blair and Stout and I agree. We part company, however, when they deny that the end towards which corporations are governed is, as the *Dodge* court put it, "the profit of the stockholders."[231]

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deteriorating effect on the neighborhood surrounding Wrigley Field. *Id*. at 778. Despite Shlensky's apparently uncontested evidence that Wrigley was more concerned with nonshareholder than with shareholder interests, the Illinois Appellate Court dismissed for failure to state a claim upon which relief could be granted. *Id*. at 778-80. Although this result on superficial examination may appear to devalue shareholder wealth maximization, on close examination the case involves nothing more than a wholly unproblematic application of the business judgment rule. *See* Bainbridge, *supra* note 56, at 978-79 (discussing *Shlensky*). In other words, I concede that the business judgment rule has the *effect* of insulating the board of directors from liability when they put the interests of nonshareholder constituencies ahead of those of shareholders, but deny that that is the rule's *intent*.

[228] 170 N.W. 668, 684 (Mich. 1919). *See supra* text accompanying note 111 (quoting relevant passage).

[229] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

[230] *Cf.* Marx v. Akers, 666 N.E.2d 1034, (N.Y. 1996) (noting that "shareholder derivative actions infringe upon the managerial discretion of corporate boards…. Consequently, we have historically been reluctant to permit shareholder derivative suits, noting that the power of courts to direct the management of a corporation's affairs should be 'exercised with restraint.'"); *see also* Pogostin v. Rice, 480 A.2d 619, 624 (noting that "the derivative action impinges on the managerial freedom of directors")

[231] *Compare Dodge*, 170 N.W. at 684 *with* Blair & Stout, *supra* note 18, at 301-02 (critiquing the *Dodge* decision).

Put another way, we agree that the business judgment rule exists to preserve director discretion, but disagree as to why that discretion is important. Blair and Stout contend that the business judgment rule insulates the board of directors from "the direct command and control" of shareholders (or other corporate constituents for that matter) so as to prevent the various constituents from opportunistically expropriating rents from the team.[232] In contrast, I contend that the business judgment rule is the doctrinal mechanism by which courts on a case-by-case basis resolve the competing claims of authority and accountability.

As a positive theory of corporate governance, director primacy claims that fiat—centralized decisionmaking—is the essential attribute of efficient corporate governance. As a normative theory of corporate governance, director primacy claims that authority and accountability cannot be reconciled. As Kenneth Arrow observed:

> [Accountability mechanisms] must be capable of correcting errors but should not be such as to destroy the genuine values of authority. Clearly, a sufficiently strict and continuous organ of [accountability] can easily amount to a denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.[233]

The business judgment rule prevents such a shift in the locus of decisionmaking authority from boards to judges. It does so by establishing a limited system for case-by-case oversight in which judicial review of the substantive merits of those decisions is avoided. The court begins with a presumption against review.[234] It then reviews the facts to determine not the quality of the decision, but rather whether the decisionmaking process was tainted by self-dealing and the like.[235] The questions asked are objective and straightforward: Did the board commit

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[232] Blair & Stout, *supra* note 18, at 746.

[233] ARROW, *supra* note 40, at 78.

[234] *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (explaining that the rule creates a presumption that the directors or officers of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company).

[235] *See, e.g.*, Kamin v. American Express Co., 383 N.Y.S.2d 807, 811 (N.Y. Sup. 1976) (stating that absent "fraud, dishonesty, or nonfeasance," the court would not substitute its judgment for that of the directors), aff'd, 387 N.Y.S.2d 993 (N.Y. A.D. 1976).

fraud? Did the board commit an illegal act? Did the board self-deal? Whether or not the board exercised reasonable care is irrelevant, as well it should be.[236] The business judgment rule thus builds a prophylactic barrier by which courts pre-commit to resisting the temptation to review the merits of the board's decision. This is precisely the rule for which shareholders would bargain,[237] because they would conclude that the systemic costs of judicial review exceed the benefits of punishing director misfeasance and malfeasance.[238]

V. CONCLUSION

Along the means axis of Figure 1, the director primacy model claims that the substantial virtues of fiat can be ensured only by preserving the board's decisionmaking authority from being trumped by either shareholders or courts. Achieving an appropriate mix between authority and accountability is a daunting—but necessary—task. Ultimately, authority and accountability cannot

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[236] *See, e.g.,* Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) (stating: "While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading.... Whatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labeled the business judgment rule."); Brehm v. Eisner, 746 A.2d 244, 262-64 (Del. 2000) (rejecting plaintiff's contention that the business judgment rule includes an element of "substantive due care" and holding that the business judgment rule requires only "process due care").

[237] Shareholder primacy-oriented critics of director primacy likely would concede that judicial review shifts some power to decide to judges but contend that that observation is normatively insufficient. To be sure, they might posit, centralized decisionmaking is an essential feature of the corporation. Judicial review could serve as a redundant control on board decisionmaking, however, without displacing the board as the primary decisionmaker. If made, this argument would reflect the preoccupation with agency costs of law and economics-oriented proponents of shareholder primacy. As noted above, we could eliminate agency costs by eliminating discretion. But we do not. To the contrary, we ensure the board's power to freely exercise discretion by creating rules that insulate the board from review by courts, shareholders, and nonshareholder constituencies alike. We do this not to allow directors to function as mediating hierarchs, but because it maximizes shareholder wealth.

[238] I plan to develop this claim more fully in a future article.

be reconciled. At some point, greater accountability necessarily makes the decisionmaking process less efficient, while highly efficient decisionmaking structures necessarily reduce accountability. In general, that tension is resolved in favor of authority. Because only shareholders are entitled to elect directors, boards of public corporations are insulated from pressure by nonshareholder corporate constituencies, such as employees or creditors. At the same time, the diffuse nature of U.S. stockownership and regulatory impediments to investor activism insulate directors from shareholder pressure. As such, the board has virtually unconstrained freedom to exercise business judgment. Preservation of this largely unfettered discretion is—and should always be—the null hypothesis. Fiat is both the defining characteristic of corporate governance and its overarching value. Hence, the term director primacy, which reflects the board's sovereignty.