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ESSAY

THE TEAM PRODUCTION THEORY OF CORPORATE LAW: A CRITICAL ASSESSMENT

ALAN J. MEESE*

For decades, economists have offered competing theories of the firm. Such theories begin by answering one straightforward question: Why do firms exist? After all, everything that a firm does could also be done "by the market," through a contract of purchase and sale.¹ A lawyer can employ a secretary to type her briefs, or she can pay a typing service to do so. Why do individuals organize firms instead of conducting their activities through market contracting? Any answer to this question begs a related one, namely, once a firm is formed, what leads it to perform some activities internally, while relying on "the market" to complete others?² (A law firm can pay its employees to make 100 copies of a brief; it can also pay the copy service across the street to do so.) These questions have occupied

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1. Steven Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1, 1-5 (1983); R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 388 (1937) ("Having regard to the fact that if production is regulated by price movements, production could be carried on without any organisation at all, well might we ask, why is there any organisation?").

2. See R.H. Coase, *The Nature of the Firm: Origin*, 4 J.L. ECON. & ORG. 3, 15-16 (1988).

the attention of many eminent economists, with seemingly fruitful results.³

A complete theory of the firm can do more than explain why individuals create firms and what those firms do; it can also help explain what type of firms people create. After all, individuals do not merely form firms: they create partnerships, sole proprietorships, and corporations, just to name a few. (Everything that a partnership does could also be done by a corporation, and vice versa.) While a robust theory of the firm should explain why two lawyers might choose to form a firm, and why that firm might choose to make its own copies instead of relying upon independent contractors, it can also explain why the lawyers might choose to organize as a partnership instead of as a sole proprietorship or a corporation.

Economists and legal scholars have spent significant effort attempting to explain why individuals might choose one form of business organization over another.⁴ In so doing, they have paid particular attention to the economics of the publicly held corporation. Thus, economists and legal scholars have sought economic explanations for various features of the public corporation that distinguish it from other forms of business organization. Why do the purported "owners" of public corporations delegate control over "their" property to managers who may have little or no financial stake in the enterprise? Why are courts so deferential to business decisions made by directors and managers of publicly held corporations who are (apparently) unaccountable as a practical matter to anyone? These and other questions have occupied scholars for some time now.

In the past two decades, a consensus of sorts has emerged about the economic function of the public corporation and the state laws that enable its formation. According to this dominant account,

3. Classic contributions include: Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Coase, *supra* note 1, *passim*; see also OLIVER WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (1985) [hereinafter WILLIAMSON, *ECONOMIC INSTITUTIONS*]; OLIVER WILLIAMSON, *MARKETS AND HIERARCHIES* (1975); George Stigler, *The Division of Labor is Limited by the Extent of the Market*, 59 J. POL. ECON. 192 (1951).

4. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *ECONOMIC STRUCTURE OF CORPORATE LAW* 1-39 (1991); HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* (1996).

enterprises choose the corporate form over other types of business organization to realize the gains produced by the separation of ownership from control.⁵ This separation enables a specialization of function: Shareholders supply capital and bear the risk that comes with their claim to the firm's residual product, and managers act as shareholders' agents, using their expertise to deploy the principals' capital in various ventures.

While the separation of ownership from control and the specialization it reflects can produce enormous benefits, it also comes with a potential cost. By placing their capital under the control of specialists, shareholders subject themselves to a unique risk of opportunism. Without any financial stake in the enterprise, managers and the directors who supervise them may shirk their duty to manage the corporation in the shareholders' interest. Thus, it is said, corporate law and the market mechanisms that support it have evolved to facilitate and preserve the specialization of function while at the same time reducing the "agency costs" that would otherwise accompany the separation of ownership from control.⁶ This "principal-agent" account of the public corporation, in turn, implies a "shareholder primacy norm," i.e., a recognition that directors and managers do and should run the corporation so as to maximize the wealth of a single owner, namely, shareholders.⁷ Because they hold an exclusive property right in the firm's residual, it is said, shareholders will internalize the costs and benefits of the firm's actions, operating, as they do, in a setting of relatively low transaction costs.⁸

Margaret Blair and Lynn Stout have offered a competing hypothesis about the nature and purposes of the public corporation.⁹ As they see things, public corporations do not "belong" to shareholders in any meaningful sense, and directors are not properly viewed as shareholder agents. Instead, directors of public

5. See *infra* notes 26-27 and accompanying text.

6. See *infra* notes 27-31, 173-85 and accompanying text.

7. See generally Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998) (describing and critiquing shareholder primacy norm). See also *infra* notes 30-31 and accompanying text.

8. See *infra* notes 41-43 and accompanying text.

9. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

corporations are best regarded as "mediating hierarchs," who are accountable to no particular constituency of the firm.¹⁰ According to Blair and Stout, the public corporation is best viewed as a team of shareholders, creditors, workers, managers, and communities.¹¹ Shareholders are not the only group that make investments that are specific to this "team": creditors, workers, managers, and communities also make investments that are most productive when employed in connection with the corporate enterprise.¹² Like shareholders, who face the risk of opportunism by managers, these other constituencies run the risk of exploitation by shareholders. As a result, it is said, these groups may be reluctant to place their human and financial capital under the control of managers and directors obligated under the shareholder primacy norm "ruthlessly [to] pursue shareholders' interests."¹³ Thus, instead of overseeing managers with a view toward maximizing the wealth of shareholders, they say, directors do and should view themselves as "mediating hierarchs" who resolve competing claims to the collective residual produced by the firm's activities.¹⁴

By depriving shareholders of an exclusive property right in the team's residual, it is said, a mediating hierarch model of governance can empower firms to make credible commitments to refrain from opportunistic behavior directed at members of the team, thus lowering the cost of obtaining team-specific investment from shareholders, creditors, employees, and communities.¹⁵ According to Blair and Stout, then, this mediating hierarch model of corporate governance can reduce the transaction costs associated with obtaining relationship-specific investments and is thus economically superior to the principal-agent model.¹⁶ This analysis is confirmed, they say, by an examination of Delaware corporate law. More precisely, Blair and Stout assert that their mediating hierarch

10. *Id.* at 276-87.

11. *Id.* at 250.

12. *Id.* at 286-87.

13. *Id.* at 280 (asserting that the principal-agent account implies such a duty by directors and managers).

14. *Id.* at 276-82.

15. See *infra* notes 55-61 and accompanying text (explaining Blair and Stout's argument to this effect).

16. Blair & Stout, *supra* note 9, at 280-84.

model provides a plausible account of numerous features of Delaware law that the principal-agent model purportedly cannot explain.¹⁷ As a result, they conclude, the mediating hierarch model should replace the principal-agent model as the paradigm scholars employ to examine and evaluate public corporation law.¹⁸

Blair and Stout are not the only scholars who have argued that directors of public corporations do and should "mediate" between competing claims of a firm's stakeholders. In recent years, several critics of the principal-agent model have reached similar conclusions and concomitantly called for rejection of the shareholder primacy norm.¹⁹ Unlike most of these scholars, however, Blair and Stout have relied solely and explicitly on the dictates of economic efficiency, eschewing noneconomic considerations such as "fairness," "social justice," and "communitarianism."²⁰ By refusing to invoke such amorphous concepts, the application of which necessarily varies from context to context, Blair and Stout have constructed a rigorous, internally coherent model with potentially universal application to any number of corporate law problems.²¹ Indeed, as noted earlier, Blair and Stout believe that this paradigm provides a complete account of the rationale for public corporations and thus the rules of corporate law that enable their formation and regulate their activities.²² Several

17. See *id.* at 287-319.

18. THOMAS KUHN, *THE STRUCTURE OF SCIENTIFIC REVOLUTION* 23-24 (2d ed. 1970) (one paradigm becomes superior to others if it solves problems or explains phenomena that other paradigms cannot solve or explain).

19. See, e.g., David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, in *PROGRESSIVE CORPORATE LAW* 1-33 (Lawrence E. Mitchell ed., 1995); Lawrence E. Mitchell, *A Critical Look At Corporate Governance*, 45 *VAND. L. REV.* 1263 (1992); Maureen A. O'Connor, *Restructuring The Corporation's Nexus Of Contracts: Recognizing A Fiduciary Duty To Protect Displaced Workers*, 69 *N.C. L. REV.* 1190 (1991); Lyman Johnson, *Individual and Collective Sovereignty In The Corporate Enterprise*, 92 *COLUM. L. REV.* 2215 (1992) (reviewing FRANK H. EASTERBROOK & DANIEL R. FICHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1996) and ROBERT N. BELLAH ET AL., *THE GOOD SOCIETY* (1991)). For a thorough normative critique of so-called "progressive corporate law" see Stephen Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 *CORNELL L. REV.* 856 (1997) (reviewing *PROGRESSIVE CORPORATE LAW* (Lawrence E. Mitchell ed., 1995)).

20. See *infra* notes 62-65 and accompanying text.

21. See KUHN, *supra* note 18, at 23-24, 109-10 (wide applicability enhances acceptance of paradigms).

22. See *infra* notes 157-68 and accompanying text (describing Blair and Stout's use of the

scholars apparently agree, and Blair and Stout's thesis has already spawned a number of articles that employ the mediating hierarch model to examine a variety of corporate law problems.²³ It would therefore appear that Blair and Stout have mounted a credible challenge to the principal-agent model and with it the shareholder primacy norm.

This Essay offers a critique of Blair and Stout's "team production theory of corporate law" and a corresponding defense of the principal-agent model. As an initial matter, it should be noted that Blair and Stout's hypothesis is not the only "team production theory of corporate law." The principal-agent account itself depends upon the team production theory, resting, as it does, on an assumption that the corporation is a "nexus of contracts" among various factors of production. At any rate, Blair and Stout's modified version of the team production theory suffers from several conceptual weaknesses, shortcomings that undermine their assertion that a mediating hierarch model of corporate governance will produce significantly lower transaction costs than the single-owner approach and associated shareholder primacy norm.

Blair and Stout concede that states have not adopted a mediating hierarch approach where private firms like partnerships and closely held corporations are concerned.²⁴ At the same time, these authors have offered no evidence or argument that participants in publicly held enterprises are particularly vulnerable to opportunism.

mediating hierarch model purportedly to explain various supposedly "puzzling" features of the law of public corporations); see also Margaret M. Blair, *A Contractarian Defense Of Corporate Philanthropy*, 28 STETSON L. REV. 27 (1998).

23. Indeed, the *Journal of Corporation Law* recently devoted an entire issue to (sympathetic) analysis and application of Blair and Stout's thesis. See Symposium, *Team Production In Business Organizations*, 24 J. CORP. L. 743-1037 (1999) (containing eight different articles applying the mediating hierarch theory to analyze various aspects of business organizations). Several other scholars have applied Blair and Stout's thesis or felt it necessary to explain why it does not apply to the particular problem they are addressing. See, e.g., Eric A. Chiappinelli, *The Moral Basis Of State Corporate Law Disclosure*, 49 CATH. U. L. REV. 697, 714-15 (2000); Mae Kuykendall, *Assessment And Evaluation: Retheorizing The Evolving Rules of Director Liability*, 8 J.L. & POL. 1, 39-44 (1999); Zenichi Shishido, *Japanese Corporate Governance: The Hidden Problems of Corporate Law and Their Solutions*, 25 DEL. J. CORP. L. 189, 193-95, 215 (2000); see also Kent Greenfield, *The Place Of Workers In Corporate Law*, 39 B.C. L. REV. 283, 287, 293-94, 300-01 (1998) (relying upon earlier draft of Blair and Stout's paper).

24. Blair & Stout, *supra* note 9, at 281-82.

Relationship-specific investments and the concomitant potential for opportunism are endemic to economic life and are not confined to enterprises organized as public corporations. Indeed, certain attributes of public corporations afford participants in such ventures protections that render them *less* susceptible to some forms of opportunism than participants in private ventures, while at the same time leaving shareholders *more* vulnerable to such conduct. Thus, the transaction costs of obtaining team-specific investment under a single-owner approach would seem to be *lower* for public corporations than for other forms of business organization, while the benefits of protecting shareholders through implementation of a shareholder primacy norm would be larger where public firms are concerned.

Of course, the mere fact that the transaction costs of obtaining specific investment in public firms are lower than similar costs in private firms does not establish the superiority of a single-owner approach in either. It may be that a well-functioning mediating hierarch model would produce lower transaction costs than a single owner model in both types of firms. Nevertheless, by focusing on the transaction cost consequences of alternative governance regimes, Blair and Stout have neglected an additional consideration, namely, the cost of ownership. By transforming the firm's residual product into common property and empowering directors to distribute this property as they see fit, a mediating hierarch approach would undermine the shareholders' role as the primary monitors of firm activity and thus severely attenuate the incentives of directors to maximize anything other than their own welfare. Thus, such an approach to corporate governance would, if anything, increase the transaction costs of inducing team-specific investment, while at the same time attenuating the specialization benefits that would otherwise result from the separation of ownership from control. These ownership costs likely explain why, as Blair and Stout concede, states have rejected a mediating hierarch model of governance for private firms. A fortiori, one would expect states to reject such an approach for public firms where the transaction costs of obtaining team specific investment are relatively low.

Adoption of the shareholder primacy norm does not require directors "ruthlessly" to pursue immediate shareholder interest at

every turn, as Blair and Stout assert.²⁵ On the contrary, directors and managers pursuing shareholder interests will have every incentive to induce various members of the team to make firm-specific investment, and thus will take those steps necessary to provide credible commitments, in the form of contracts or otherwise, to refrain from opportunism. Firms that ignore such commitments in the quest for short-term gain will most likely harm shareholders in the long run by raising the cost of obtaining team-specific investment in the future. Refusal to pursue opportunistic business tactics, then, is perfectly consistent with the principal-agent conception of the public corporation.

Careful analysis of corporate law and the institutional arrangements that support it confirms that Delaware at least has embraced a single-owner approach to governance of publicly held corporations. To be sure, Blair and Stout have cited certain attributes of corporate law that, when viewed in the abstract, might appear inconsistent with the shareholder primacy norm inherent in the principal-agent model. However, each of these doctrines is perfectly consistent with the principal-agent model, particularly when one considers the various market mechanisms that have evolved to align the interests of shareholders and directors. The existence of these mechanisms, which take the place of legal regulation of director conduct by inducing directors to pursue shareholder interests to the exclusion of others, would itself appear inconsistent with a mediating hierarch model of firm governance. Indeed, scholars who espouse the principal-agent view have applauded many of the attributes of corporate law that Blair and Stout have invoked.

Moreover, Blair and Stout have misstated some doctrines and overlooked others that are flatly inconsistent with a mediating hierarch approach and can only be explained by a principal-agent conception of the public corporation. Finally, Blair and Stout have not explained why states have declined to adopt explicitly a mediating hierarch approach, refusing to mandate control of firms by disinterested outside directors as many have proposed. While corporate law allows firms to construct their boards in this manner,

25. *Id.* at 280.

most have rejected such an approach and reposed practical authority over firm affairs in the hands of inside directors who are emphatically not mediating hierarchs. In the end, adoption of a mediating hierarchy approach to corporate governance would require Delaware to alter its corporate law in a variety of ways.

Part I of this Essay reviews the traditional principal-agent conception of the public corporation and summarizes Blair and Stout's challenge to it. Part II identifies several theoretical flaws in Blair and Stout's argument, flaws that undermine their assertion that a mediating hierarchy approach to governing the public corporation is economically superior to a single-owner approach. Part III rebuts Blair and Stout's descriptive claim that Delaware's law of public corporations reflects the adoption of a mediating hierarchy model of corporate governance.

BLAIR AND STOUT'S CHALLENGE TO THE PRINCIPAL-AGENT MODEL

As noted earlier, most scholars characterize the modern public corporation and the laws that create it as an institutional arrangement that facilitates the separation of ownership from control.²⁶ While the traditional business firm unites these two functions—law firm partners run the firm *and* bear the associated risks—the public corporation allows for their separation. Shareholders contribute capital and bear risk, while managers act as shareholder agents and direct that capital in what are hopefully profit-making ventures. Such separation creates the possibility of significant gains from specialization. Many individuals may have capital to invest in a business enterprise and at the same time lack the business acumen necessary to manage such a business. Others might have such acumen, but nevertheless wish to diversify their holdings by investing small sums in several different firms, without committing permanently to participation in any particular enterprise. Managers, by contrast, might have significant expertise but lack the capital necessary to undertake the enterprise in question. By agreeing to coordinate the utilization of their respective

26. See, e.g., EASTERBROOK & FISCHER, *supra* note 4, at 1-39; Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON L. REV. 99 (1989).

resources through a public corporation, then, shareholders and managers can place large sums of capital in the hands of specialist managers and thus realize gains not obtainable by firms in which ownership and control must be exercised by a single individual or group of individuals.²⁷

While the separation of ownership from control is a necessary condition for achieving significant gains from specialization, it does not by itself produce such gains. For separation to produce the desired results, shareholders must resist the temptation to second-guess managers, and managers must diligently seek to advance shareholder interests. By its nature, however, separation creates the risk that neither of these conditions will be satisfied. Because they do not share in the profits (or losses) generated by their efforts, managers may have little incentive to pursue their duties with diligence.²⁸ Such shirking could attenuate the gains produced by the separation of ownership from control, and cause shareholders to spend resources monitoring managers' actions. This monitoring could be especially costly, as shareholders spend significant resources gathering information and exercising day-to-day control over firm operations. Taken together, these two costs—manager shirking and shareholder monitoring—constitute the costs of agency implicit in the separation of ownership from control.²⁹

The law of public corporations, it is said, is designed to facilitate the separation of ownership from control and the specialization it implies, while at the same time minimizing agency costs. Managers run the firm on a daily basis, and shareholders have no power to

27. See ROBERT C. CLARK, *CORPORATE LAW* 1-24 (1986); EASTERBROOK & FISCHEL, *supra* note 4, at 11.

28.

The directors of [joint stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. . . . Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

MICHAEL P. DOOLEY, *FUNDAMENTALS OF CORPORATION LAW* 197 (1995) (quoting ADAM SMITH, *THE WEALTH OF NATIONS* 700 (Cannan ed., 1937) (1776)) (alteration in the original).

29. EASTERBROOK & FISCHEL, *supra* note 4, at 11; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

countermand their decisions. Moreover, shareholders can purchase small stakes that are readily transferable to other purchasers and are "on the hook" only for their initial investment. Therefore, they need not fear loss of their individual fortunes should something go wrong.³⁰ At the same time, shareholders employ directors to oversee managers, and both are duty-bound to deploy the firm's resources in a manner that maximizes shareholder welfare. Implicit in this conception of the public corporation is the norm of shareholder primacy, i.e., that directors and managers should run the public corporation so as to maximize the residual available to shareholders.³¹

Blair and Stout offer an alternative conception of the public corporation, a conception that draws upon the "team production" theory of the firm.³² First advanced by Armen Alchian and Harold Demsetz, the team production theory builds upon Professor Coase's assertion that the firm is a vehicle for avoiding the costs associated with market transacting.³³ Much economic activity, it is said, involves production by teams. Because team production involves joint effort, however, it is often difficult to measure the contribution of each member of the team to the final product, and thus difficult to determine how team members should divide the profits

30. EASTERBROOK & FISCHER, *supra* note 4, at 11, 41-44 (discussing link between limited liability and separation of ownership from control).

31. *Id.* at 67-70; see also Smith, *supra* note 7, at 280-83 (describing "contractarian" support for shareholder primacy norm).

32. See Blair & Stout, *supra* note 9.

33. Alchian & Demsetz, *supra* note 3, at 777. Professor Coase first articulated the conventional approach. Coase, *supra* note 1, *passim*. Some may be puzzled by the assertion that the team production theory "builds upon" Coase's work. After all, Alchian and Demsetz explicitly rejected Coase's assertion that there is a meaningful distinction between the authority exercised "within" a firm and the authority a firm can exercise by contract. Alchian & Demsetz, *supra* note 3, at 777-78; see also Scott E. Masten, *A Legal Basis for the Firm*, 4 J.L. ECON. & ORG. 181, 182-83 (1988). Although Alchian and Demsetz certainly disagreed with Coase's account of what makes a firm a firm, their team production theory ultimately rests on an assertion that certain forms of transaction costs, notably, the cost of information, lead individuals to rely upon the institutional device known as a firm to organize production and distribute the proceeds. This account would seem to fall squarely within the Coasean tradition. Indeed, Alchian and Demsetz note that there may be other sorts of "policing" costs that might lead to the formation of firms. Alchian & Demsetz, *supra* note 3, at 785. See generally Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 311-12 (1993) (describing link between Coase's work and that of Alchian and Demsetz).

generated by their activity.³⁴ Theoretically, of course, members could agree in advance how they will divide the fruits of their joint product. If such an agreement is reached, however, each team member will have an incentive to shirk, knowing that most of the cost of such slacking will be borne by other members of the team.³⁵

The creation of a firm, it is said, is one way of enhancing the benefits of team production given the costs of organizing such production through ordinary market contracting. By empowering a monitor to hire, observe, and reward various inputs, the institution of a firm can facilitate and maximize the value of team production.³⁶ Theoretically, the monitor could be a disinterested third party, who directs the team for a fixed compensation. Such an arrangement would presumably lead to shirking by the monitor, who would have no incentive to discharge its duties with diligence.³⁷ This danger can be averted, however, by assigning the monitor a property right to the residual fruits of the team's effort, thus creating the appropriate incentives to run the team so as to maximize its combined product.³⁸ According to Alchian and Demsetz, these considerations give rise to the paradigmatic business firm: An owner, who enters contracts with employees and other suppliers, sells the output produced by this team, and pockets the residual.³⁹

As described thus far, the team production theory of the firm would seem to bolster the traditional "principal-agent" conception of the public corporation and, with it, the shareholder primacy norm.⁴⁰ Under the principal-agent account, shareholders possess an exclusive property right to the firm's residual product and thus

34. Alchian & Demsetz, *supra* note 3, at 779-80.

35. *Id.* at 780.

36. *Id.* at 781-83.

37. *Id.* at 782 (asking "But who will monitor the monitor?").

38. *Id.* at 782-83.

39. *Id.* at 794:

The essence of the classical firm is identified here as a contractual structure with: 1) joint input production; 2) several input owners; 3) one party who is common to all the contracts of the joint inputs; 4) who has rights to renegotiate any input's contract independently of contracts with other input owners; 5) who holds the residual claim; and 6) who has the right to sell his central contractual residual status.

40. See EASTERBROOK & FISCHEL, *supra* note 4, at 9-11 (describing corporations and other firms as teams of individuals prone to shirking).

possess incentives to monitor performance of the team.⁴¹ Because they are in a position to transact with various team members, shareholders internalize the costs and benefits of the firm's actions, and thus possess incentives to maximize the value of the team's production.⁴² Shareholders do not transact or engage in such monitoring themselves, but instead employ specialized agents—managers and directors—to do so on their behalf.⁴³ This specialization, in turn, gives rise to a separation of ownership from control—a separation that creates the risk that the agent (manager or director) will discharge its responsibilities in a manner inconsistent with the interests of the principal. Indeed, leading proponents of the principal-agent approach consistently refer to the public corporation as a “nexus of contracts” between a central contracting agent and various factors of production, and often characterize the corporation as a device for maximizing the gains from team production.⁴⁴ The principal-agent conception is as much a “team production theory” as Blair and Stout's proposal.

Nevertheless, Blair and Stout reject the principal-agent conception of the public corporation by modifying and extending the team production theory. As they point out, team production often requires individuals to make team-specific investments—that is,

41. See HAROLD DEMSETZ, *OWNERSHIP, CONTROL AND THE FIRM* 231 (1988) (noting that the ability of shareholders to amass large blocks facilitates monitoring of management and that “collectively owned assets . . . do not offer a practical substitute for a large private and personal equity stake”); Alchian & Demsetz, *supra* note 3, at 787-88.

42. Alchian & Demsetz, *supra* note 3, at 787-88; see also Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960); Richard A. Epstein, *Holdouts, Externalities and the Single Owner: One More Salute to Ronald Coase*, 36 J.L. & ECON. 553, 556-57 (1993).

43. See Alchian & Demsetz, *supra* note 3, at 788.

44. EASTERBROOK & FISCHER, *supra* note 4, at 8-11 (articulating “nexus of contracts” conception of firms generally and public corporations in particular); *id.* at 10 (“[W]e have been describing the firm as an extra-market, team method of production . . . [c]orporations are a subset of firms.”); *id.* at 172-73 (arguing that potential bidders for firm's shares serve as monitors of management teams); Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179 (1985) (characterizing the corporation as a “nexus of contracts”); Butler, *supra* note 26, at 103-10 (relying in part on team production theory to derive and bolster nexus of contracts conception of the corporation); see also William W. Bratton, Jr., *The “Nexus of Contracts” Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 415-17 (1989) (stating that the “nexus of contracts” approach is built on the team production theory); Thomas Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 319-20 (1993) (showing that “nexus of contracts” conception of corporation derives from “team production” theory).

investments that are most useful when used in conjunction with the activities of the team.⁴⁵ So, for instance, an employee might invest in significant training or effort that develops talents that are only useful, or most useful, to a particular firm. Because team members cannot take such investments elsewhere, they face the risk that other team members, particularly the residual claimant(s), will exploit them by appropriating the gains of such investments to themselves.⁴⁶ A salesperson, for instance, may spend decades cultivating particular customers for her firm, expecting a high wage that reflects the cost of these efforts and their value to the company.⁴⁷ Once these efforts have been made, however, residual claimants could capture the gains created by terminating the salesperson and transferring her customers to a newly hired (and lower paid) successor.⁴⁸ To be sure, various team members could protect themselves against such opportunism by contract, refusing to join the team or demanding higher wages from those owners that do not provide credible guarantees against opportunism. These guarantees could take several forms, including detailed contracts or "hostages" that deter opportunism.⁴⁹ According to Blair and Stout, however, such arrangements are costly to negotiate and enforce, and they can reduce the sort of flexibility necessary to the long-term health of a complex enterprise.⁵⁰

Society, then, faces a problem. Efficient wealth creation requires team production, production that is organized by firms and often involves team-specific investment by several constituencies such as creditors, employees, shareholders, and communities. If these firms adopt a "single-owner" model of governance, the possibility of opportunism by residual claimants may make potential members

45. Blair & Stout, *supra* note 9, at 272-73.

46. *Id.* at 272-74.

47. *Id.* at 276 ("The marketing specialist, for example, must develop specialized knowledge and personal contacts (firm-specific human capital) whose value is vulnerable to actions and decisions of the team as a whole . . .").

48. HANSMANN, *supra* note 4, at 26 (describing problem of opportunism directed at employees who have made team-specific investments).

49. *E.g.*, WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 169-89 (describing how firms can create credible commitments against opportunism by giving a hostage). For instance, a corporation could make investments that are specific to a particular location as a means of committing not to move elsewhere.

50. Blair & Stout, *supra* note 9, at 273.

reluctant to join the team, if joining requires them to make investments specific to the relationship. Such reluctance in turn will increase the costs of obtaining team-specific investment through market contracting, that is, transaction costs.⁵¹ Effective team production would seem to require some mechanism of governance that obviates the risk of opportunism inherent in the single-owner model of the business firm.

As Blair and Stout see things, the public corporation is just such an institutional arrangement. Like other types of business enterprise, the public corporation involves the coordination of a variety of inputs: capital, labor, and management. According to Blair and Stout, however, the public corporation differs from other enterprises in one crucial respect: it lacks a single owner, i.e., a residual claimant that can control the enterprise for its exclusive benefit. Sole proprietorships, partnerships, and closely held corporations all possess identifiable owners, who exercise control over the enterprise and can assert an exclusive property right over its profits.⁵² The public corporation, on the other hand, is owned by no particular individual or group: various groups make team-specific investments and thus can claim entitlement to a portion of the residual benefits of the team's activity.⁵³

Although nominally subject to election by common shareholders, directors of public corporations are, as a practical matter, accountable to no one.⁵⁴ Because shareholders possess no particular property right in the firm's product, the directors of such a firm are in a position to act as neutral hierarchs, mediating the competing claims that various team members might have to the collective residual benefits of the team's activities. In so doing, they can pursue policies that maximize the joint welfare of the team, and not merely the welfare of a single constituency, such as the shareholders.⁵⁵ As a result, firms will be able to make a credible

51. Cf. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 20-22 (defining "transaction cost" as any cost that results from reliance upon markets instead of "directing" economic activity within firms); Carl J. Dahlman, *The Problem of Externality*, 22 J. L. & ECON. 141, 144-47 (1979) (same).

52. Blair & Stout, *supra* note 9, at 275, 281.

53. *Id.* at 275-87.

54. *Id.* at 310-11.

55. *Id.* at 277-78.

commitment to refrain from exploiting individuals who have made team-specific investments.⁵⁶ Knowing that the hierarchy will not "ruthlessly pursue shareholders' interests at the expense of employees, creditors, or other team members,"⁵⁷ potential team members will be more willing to make the sort of relationship-specific investments that can maximize the value of team production.⁵⁸ Thus, the cost of obtaining such investments by market contracting—transaction costs—will be lower than the costs that would afflict a firm that pursued a single-owner approach.⁵⁹ The law of public corporations, then, provides a mediating hierarchy system of governance and thus minimizes transaction costs for those enterprises that involve the sort of team-specific investment that renders constituents vulnerable to opportunism.⁶⁰ Indeed, Blair and Stout's thesis is distinguished more by its reliance on the mediating hierarchy system of governance than the team production theory as such.⁶¹

Because Blair and Stout would discard the norm of shareholder primacy, some may associate their argument with "progressive" calls for corporate social responsibility, i.e., the sacrifice by corporations of efficiency and shareholder profits in furtherance of other concerns.⁶² Blair and Stout, however, expressly disassociate themselves from the progressive movement, and with good reason.⁶³ Like many proponents of the principal-agent conception and related shareholder primacy norm, Blair and Stout assume that a corporation is usefully characterized as a "nexus of contracts" and that states do and should craft corporate law so as to maximize

56. Cf. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 167-89 (arguing that ability to make a credible commitment to refrain from opportunism can reduce the transaction costs of obtaining relationship-specific investment).

57. Blair & Stout, *supra* note 9, at 280.

58. *Id.* at 276-80.

59. *Id.* at 271-82.

60. *Id.* at 275-78.

61. Cf. *id.* at 319-28 (repeatedly referring to their "mediating hierarchy model" of firm governance); see also *supra* notes 40-44 and accompanying text (showing that principal-agent account is also a team production theory).

62. See, e.g., *PROGRESSIVE CORPORATE LAW* (Lawrence E. Mitchell ed., 1995); David Millon, *Redefining Corporate Law*, 24 *IND. L. REV.* 223 (1991).

63. See Blair & Stout, *supra* note 9, at 253-54.

social wealth.⁶⁴ To be sure, the mediating hierarch conception of the public corporation may produce results that might seem more “fair” and “just” to some than the results produced by a shareholder primacy model. To Blair and Stout, however, this attribute is purely incidental. As they see things, states have adopted the mediating hierarch conception of the public corporation for hard-headed reasons of efficiency. More precisely, states have embraced the mediating hierarch concept because it is superior to competing institutional arrangements for certain classes of enterprises, namely, those that require production by teams of individuals that must make relationship-specific investments that enhance the risk of opportunism.⁶⁵

THE PROHIBITIVE COSTS OF A MEDIATING HIERARCH GOVERNANCE MODEL

Blair and Stout assert that a mediating hierarch approach to governing public corporations will minimize the transaction costs associated with the team-specific investment that distinguishes such enterprises from those that employ a single-owner model and thus maximize social welfare. As shown below, Blair and Stout’s theoretical argument falls short for two different reasons. First, these scholars have failed to show that opportunism induced by team-specific investment is more prevalent in publicly held firms than in private enterprises organized along a single-owner model. Team-specific investment is endemic to economic life and is in no way limited to the sort of large-scale enterprises that tend to organize as public corporations. Indeed, certain inherent attributes of publicly held corporations actually reduce the risk of opportunism faced by some constituencies and *increase* the risk faced by shareholders. Thus, one would expect the transaction costs of inducing team-specific investments by nonshareholder constituents to be *lower* for public corporations organized along a principal-agent model than for private firms. One would also expect the transaction costs of obtaining shareholder investment to be *higher* in public

64. *Id.* at 254.

65. *Id.* at 276-87; *id.* at 287-315 (arguing that Delaware law in fact reflects a mediating hierarch approach).

corporations that depart from the shareholder primacy norm than in similar private firms. These results seem to undermine any assertion that public corporations should employ a governance model different from that employed by single-owner private firms.

Second, even if a mediating hierarch model of firm governance could theoretically produce lower transaction costs than a single-owner approach, adoption of such a model would entail significant "ownership costs." By divesting shareholders of any property right in the firm's residual, such an approach would deprive directors of any incentives to maximize the welfare of teams or to refrain from opportunism. As a result, firms would lack the ability to make the sort of credible commitment necessary to attract team-specific investment. Moreover, mediating hierarchs would have little incentive to maximize anything aside from their own welfare, thus depriving society of the specialization benefits ordinarily associated with adoption of the corporate form. These ownership costs would afflict all corporate decision making and thus outweigh any marginal gains that a mediating hierarch approach might otherwise produce.

A. *Transaction Costs*

As noted earlier, conventional wisdom holds that the public corporation is a business form designed to facilitate realization of the specialization benefits produced by the separation of ownership from control.⁶⁶ In particular, the corporate form allows an enterprise to aggregate capital from innumerable contributors and place that capital in the hands of specialized management.⁶⁷ Moreover, common sense and economic theory suggest that these specialization benefits will be the greatest where the enterprise in question requires large amounts of capital that no entrepreneur or group of entrepreneurs can supply. Thus, scholars have traditionally associated adoption of the corporate form with technological advances that increased the minimum efficient scale in many industries previously dominated by smaller, privately held firms.⁶⁸

66. See *supra* notes 26-27 and accompanying text.

67. See *supra* note 27 and accompanying text.

68. See CLARK, *supra* note 27, at 2-3 (describing efficiency rationales for growth in

Blair and Stout do not challenge this traditional account of the rationale for the corporate form of organization; nor could they—no one can dispute that the average publicly held corporation has a larger capitalization and operates at a larger scale than the average proprietorship, partnership, or closely held corporation.⁶⁹ Moreover, their modification of the team production theory does not purport to explain certain central features of the public corporation, namely, wide dispersion of share ownership and delegation of control to specialist managers with no stake in the firm. Instead, Blair and Stout's account is apparently designed merely to supplement the traditional explanation, while at the same time suggesting rejection of the shareholder primacy norm for such firms. Indeed, they expressly state that a desire to attract specific investment "in part" explains the decision to conduct an enterprise as a public corporation, thus seeming to concede that there can be other (partial) explanations as well.⁷⁰

Although they acknowledge that team production concerns can provide only a partial explanation for a firm's decision to "go public," Blair and Stout assert that such firms necessarily opt into a mandatory mediating hierarch model of firm governance.⁷¹ At the same time, Blair and Stout concede that sole proprietorships, partnerships, closely held corporations, and the like do not reflect a mediating hierarch approach to firm governance but instead are

optimal firm size and associated rise of publicly held corporations); WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 273-89; Harold Demsetz, *Toward a Theory of Property Rights*, 57 AM. ECON. REV. 347, 358 (1967). Demsetz notes that:

[S]ignificant economies of scale in the operation of large corporations is a fact and . . . large requirements for equity capital can be satisfied more cheaply by acquiring the capital from many purchasers of equity shares. While economies of scale in operating these enterprises exist, economies of scale in the provision of capital do not. Hence, it becomes desirable for many "owners" to form a joint-stock company.

Id.

69. See CLARK, *supra* note 27, at 1-2.

70. See Blair & Stout, *supra* note 9, at 281 (stating that "the choice to 'go public' may be driven in part by team production considerations") (emphasis added).

71. See *id.* at 309 (suggesting that firms can opt out of mediating hierarch model by going private); cf. Jonathan Macey, *Corporate Law and Corporate Governance A Contractual Perspective*, 18 J. CORP. L. 185, 186-87 (1993) (discussing distinction between mandatory and so-called "enabling" rules).

characterized by single-owner approaches.⁷² In other words, Blair and Stout assert that the same states that have sought to maximize wealth by embracing a mediating hierarch structure for publicly held corporations have adopted a single-owner approach for other firms. Thus, Blair and Stout's argument depends upon a critical assumption, namely, that enterprises that, for whatever reason, choose to organize as public corporations generally entail team-specific investments and a resulting risk of opportunism greater than that found in private firms.

The assumption that private firms proceed on a single-owner model seems irrebuttable: New York's law of partnership does not require the partners at Wall Street law firms to mediate between competing claims by associates and creditors to the firms' residuals. Blair and Stout therefore bear some burden of proving that, in fact, opportunism is more prevalent in larger enterprises of the sort that organize themselves as public corporations. Failure to carry this burden, it seems, would undermine any assertion that special risks of opportunism require departure from the single-owner approach where public corporations are concerned.

As shown below, there is no reason to believe that participants in enterprises organized as public corporations face special risks of opportunism. First, Blair and Stout adduce no evidence that firms that choose to organize as public corporations involve more specific investment than partnerships, closely held corporations, and the like; indeed, casual empiricism suggests otherwise. Second, even if publicly held firms do involve a disproportionate amount of team-specific investment, such firms by their nature share various attributes that render employees and creditors *less* vulnerable to opportunism than their counterparts in privately held firms. Moreover, shareholders of publicly held firms will be subject to a *greater* risk of opportunism than the owners of private companies. These attributes, it should be emphasized, are independent of governance structure and are instead a function of various inherent characteristics of publicly held firms: large scale, perpetual life, and dispersion of share ownership. Thus, the case for adopting a mediating hierarch approach to firm governance is actually *weaker*

72. See Blair & Stout, *supra* note 9, at 273-76.

where the public corporation is concerned than it is with respect to smaller, private companies. If a single-owner approach is efficient for private firms, it would seem to follow that it is efficient for public firms as well.

As noted above, Blair and Stout do attempt to explain why states have not embraced the mediating hierarch model for partnerships, closely held corporations, and the like. Participants in such firms, they suggest, do not face the same threat of debilitating opportunism that might be present in public corporations. In particular, Blair and Stout assert that, in private firms, only one individual or group's investment may be specific to the success of the enterprise, with the result that other groups are not susceptible to exploitation.⁷³ These enterprises, they say, can mitigate the possibility of opportunism by assigning an exclusive property right in the firm's profits to the constituency that would otherwise be vulnerable to such conduct.⁷⁴ Moreover, in those instances where several participants in private firms do make team-specific investments, nonowners can purportedly protect themselves against opportunism through market contracting.⁷⁵ These enterprises, then, can organize as single-owner firms without significantly hampering their ability to attract firm-specific investments.⁷⁶

Blair and Stout, however, offer no empirical evidence that the sort of enterprises organized as private firms in fact involve less team-specific investment than those organized as public corporations. Nor do they offer any theoretical argument suggesting a correlation between factors that lead firms to "go public" and the risk of opportunism. Finally, they do not explain why participants in smaller firms are better able to protect themselves against opportunism via market contracting. Thus, their argument seems to boil down to an *assertion* that, because a mediating hierarch approach to corporate governance is a superior method of attracting

73. *Id.* at 281-82.

74. *Id.* at 281; *see also id.* at 273-76; *cf.* HANSMANN, *supra* note 4, at 53-56 (explaining that investor-owned firms minimize the costs of opportunism by assigning sole ownership rights to suppliers of financial capital).

75. Blair & Stout, *supra* note 9, at 282 (stating that enterprises not organized as public corporations may face "relatively few obstacles to explicit contracting over the division of any surplus").

76. *See id.* at 281-82.

and coordinating team-specific investment, then it must be *empirically* true that participants in enterprises organized as single-owner firms are less susceptible to opportunism.⁷⁷

There is good reason to doubt this claim. Economic activity performed by nonpublic firms routinely requires several constituencies to make firm-specific investments, and explicit contracts can be imperfect methods of preventing opportunism.⁷⁸ Indeed, Professor Alchian, on whose "team production" theory Blair and Stout rely, has argued that *all* firms consist of a coalition of various input owners that have made investments specific to resources owned by other members of the coalition.⁷⁹ Casual empiricism confirms Professor Alchian's assertion. For instance, numerous closely held corporations exist among the nation's larger business enterprises, and these firms undoubtedly involve significant team-specific investment by numerous constituencies.⁸⁰ Or, consider a medium-sized law firm that specializes in litigation. One team member—the rainmaker—convinces the client to use the firm's services. Another—a senior litigation partner—takes on the responsibility for the case. A pretrial brief is required, in support of a motion for summary judgment. The senior partner assigns this task to a senior associate. The senior associate, in turn, seeks a research memo from a mid-level associate before she drafts the brief. Once drafted, the brief is reviewed by the senior litigation partner, who signs it on the firm's behalf.

This, of course, is classic team production: if the client prevails, it is very difficult to value the respective contributions of each

77. *See id.*

78. *See, e.g.,* WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 52-56 (explaining that relationship-specific investments are necessary for risk of opportunism to be present); Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981); Oliver Williamson, *Technology and Transaction Cost Economics*, 10 J. ECON. BEHAV. & ORG. 355 (1988) (articulating rebuttable presumption that firm boundaries and characteristics are determined by risk of opportunism and associated transaction cost considerations).

79. Armen A. Alchian, *Specificity, Specialization, and Coalitions*, 140 J. INST. & THEORETICAL ECON. 34, 36-40 (1984).

80. Large closely held corporations include Cargill, Amway, Hallmark Cards, Enterprise Rent-A-Car, Koch Enterprises, and S & P Co., which manufactures Pabst, Old Milwaukee, Schlitz, Old Style, and Lone Star beers. These firms are all major participants in their respective industries. There is no reason to suspect that they involve less team-specific investment than their publicly held competitors.

member of the litigation team.⁸¹ Moreover, each member of the team has made investments in human capital that are specific to the case, as well as investments specific to the firm. The rainmaker, for instance, has spent several years cultivating clients that are "just right" for the sort of expertise offered by the firm.⁸² The litigation partner has developed talents useful to the sort of cases these clients might face. The senior associate has spent seven years cultivating relationships within the firm and learning how to generate business outside of it. The mid-level associate has recently moved to the area and purchased a house in the suburbs. Each of these individuals is theoretically susceptible to opportunism by others in the firm. Senior associates or junior partners, for instance, may "grab" the rainmaker's clients and leave the firm.⁸³ Partners may refuse to promote or even fire associates, thus depriving them of anticipated deferred compensation.⁸⁴ It does not appear possible to devise explicit contracts that entirely eliminate such behavior.⁸⁵ Moreover, it does not appear that the type or degree of such opportunism is any different from the sort of opportunism that may beset, say, a multinational automobile manufacturer. Still, small and medium-sized law firms are not organized as public

81. See Fred S. McChesney, *Team Production, Monitoring, and Profit Sharing in Law Firms: An Alternative Hypothesis*, 11 J. LEGAL STUD. 379 (1982) (using team production theory to explain structure and conduct of law firm partnerships).

82. See Marc S. Galanter & Thomas M. Palay, *Large Law Firm Misery: It's the Tournament, Not the Money*, 52 VAND. L. REV. 953, 960 (1999); Ronald J. Gilson & Robert H. Mnookin, *Coming of Age in a Corporate Law Firm: The Economics of Associate Career Patterns*, 41 STAN. L. REV. 567, 577-78 (1989).

83. See Galanter & Palay, *supra* note 82, at 959-60 (discussing this form of opportunism); Gilson & Mnookin, *supra* note 82, at 573.

84. Galanter & Palay, *supra* note 82, at 960; Gilson & Mnookin, *supra* note 82, at 577-78.

85. Law firm associates, for instance, almost always work pursuant to "at will" contracts, thus suggesting that contractual protection against opportunism is not practicable. Of course, contract law is not the only mechanism that can protect employees from opportunism. A law firm that exercises its power of termination arbitrarily will suffer reputational losses, thus making it more difficult to hire associates in the future. See Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 967-68 (1984). The same is true, however, for a public corporation. *Id.* at 968 (suggesting that larger corporations suffer greater reputational losses from arbitrary dismissals than smaller firms). Thus, there is no reason to believe that employees of public corporations are particularly subject to opportunism.

On the other hand, it would seem that firms could draft contracts that in some cases prevent departing associates from taking clients with them, so long as such agreements are limited in scope and duration. In the same way, of course, a public corporation could contract with its salespersons so as to prevent them from taking the firm's customers to a competitor.

corporations, and Blair and Stout concede that states have rejected the mediating hierarch model for these businesses in favor of a single-owner approach. Such firms do induce team-specific investment, without constituting their managing partners as mediating hierarchs. To be sure, inducing such investment is not costless; the risk of opportunism does produce some transaction costs. Still, the risk of opportunism and the transaction costs that result are not exogenous, but are instead a function of various legal rules and contractual arrangements that have evolved to minimize those costs.⁸⁶ By relying on these mechanisms, firms are able to attract significant specific investment.

Similar reasoning suggests that team-specific investments in *financial* capital are equally prevalent in public and private firms. There is no doubt that creditors who loan money to publicly held corporations thereby make a team-specific investment; if the firm fails, a creditor will not be able to take its investment elsewhere.⁸⁷ As a result, such creditors necessarily incur a risk of exploitation by owners who may, for instance, make unnecessarily risky investments. The very same is true, however, for those who loan money to partnerships or closely held corporations. Whether the "team" is Exxon-Mobil or the local auto repair shop, those who loan money to the enterprise are thereby "locked in" and will be left "holding the bag" if risky investments lead to bankruptcy.

Indeed, it would appear that participation in smaller enterprises routinely organized as partnerships or closely held corporations would pose a *greater* risk of opportunism to some constituents than would participation in a single-owner enterprise with the attributes of a public corporation. Consider, for instance, the plight of creditors. According to Blair and Stout, creditors in publicly held

86. Cf. RONALD H. COASE, *THE FIRM, THE MARKET, AND THE LAW* 27-28 (1988) (arguing that background legal rules can affect the cost of transacting); Ronald H. Coase, *The Institutional Structure of Production*, 82 AM. ECON. REV. 713, 717-18 (1992) (same); see also Alan J. Meese, *Regulation of Franchisor Opportunism and Production of the Institutional Framework: Federal Monopoly or Competition Between the States?*, 23 HARV. J.L. & PUB. POL'Y, 61, 70-77 (1999) (showing that various doctrines of contract law can reduce the transaction costs associated with opportunism in the franchising context).

87. See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 304 ("However described, suppliers of finance bear a unique relation to the firm: The whole of their investment in the firm is potentially placed at hazard."); Blair & Stout, *supra* note 9, at 276, n.61.

corporations are more susceptible to opportunism than those in smaller, privately held firms. This assertion appears to be incorrect. Firms that sell debt in public markets are subject to disclosure requirements not applicable to firms that obtain credit privately.⁸⁸ Moreover, firms that participate in national capital markets are scrutinized carefully by sophisticated market analysts who provide low-cost information to institutions and individuals that buy and hold debt securities.⁸⁹ Publicly held corporations have a perpetual existence and borrow from repeat players, and those that attempt to exploit creditors by, for instance, pursuing unduly risky business strategies will see the price of their debt fall and find it difficult to sell such debt in the future.⁹⁰ Smaller private firms, on the other hand, may have little reputational capital at stake; these firms can exploit one set of creditors without alerting potential future creditors to the firm's bad faith.⁹¹ Thus, it would seem that creditors

88. LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 172 (3d ed. 1995) (describing application of federal securities laws to debt securities).

89. Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27, 48 (1996) ("Information intermediaries (underwriters and bond rating agencies) vouch for the existence and effectiveness of terms in bond indentures.").

90. See Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 182 (noting that firms that appear likely to engage in risky conduct will pay a premium to bond purchasers); Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 434 (1986); Van Der Weide, *supra* note 89, at 45 ("Creditors avoid firms with a reputation for abusing debtholders.").

91. See J. Mark Ramseyer, *Legal Rules In Repeated Deals: Banking In the Shadow of Defection in Japan*, 20 J. LEG. STUD. 91, 96-97 (1991) (arguing that small debtors may lack the sort of reputation necessary to assure performance); Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1451-52 (1983) (showing that a firm that lends to one-time unsophisticated customers will be able to obtain unduly advantageous credit terms); cf. *Eastman Kodak Co. v. Image Technical Serv., Inc.*, 504 U.S. 451, 475-76 (1992) (asserting that manufacturer of durable goods could pursue strategy of opportunism against recent customers without jeopardizing future sales if information costs prevent future purchasers from recognizing possibility of opportunism); Victor P. Goldberg, *Institutional Change and the Quasi-Invisible Hand*, 17 J.L. & ECON. 461, 485 (1974) (suggesting that discrimination between sophisticated and unsophisticated customers can facilitate opportunism and lead to "lemons" equilibrium in contractual terms). But see WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 305 (noting that firms that obtain credit from friends or family can apply informal sanctions not available to larger firms). Nevertheless, Professor Williamson ultimately concludes that creditors of publicly held firms can protect themselves from opportunism by contract.

One could argue that such exploitation would be less prevalent for closely held

of publicly held firms are in many cases less susceptible to opportunism than those who loan money to private firms.

Of course, market-based incentives may not always prevent the residual claimants of a public corporation from exploiting creditors. Like smaller firms, publicly held firms sometimes find themselves in the final period, despite their potential perpetual existence. Moreover, one could argue that some market-based mechanisms are endogenous, i.e., arise to combat the threat of opportunism, even if such mechanisms are reinforced by certain inherent attributes of the publicly held firm.⁹² If so, the existence of such mechanisms does not necessarily suggest that creditors are invulnerable to such conduct. Yet, creditors of publicly held firms have another method of protecting themselves from opportunism, a method that may not be practically available to creditors of smaller firms, namely, market contracting. Unlike smaller firms, which raise debt capital from friends, families, or perhaps local banks, publicly held firms usually sell debt to underwriters, who can in turn sell to sophisticated investors or institutions.⁹³ Given the size of such offerings, these creditors can rationally invest significant resources in anticipating various contingencies and drafting bond covenants to protect against them.⁹⁴ Far from making contractual protection

corporations than for, say, partnerships, as the former have perpetual life. Nevertheless, one suspects that the average life of a publicly traded firm is longer than that of a closely held one, with the result that the desire to protect firm reputation will deter opportunism more completely where public corporations are concerned.

92. See *infra* notes 110-16 and accompanying text (suggesting that some market mechanisms that reduce agency costs are endogenous to the threat of opportunism against shareholders); HANSMANN, *supra* note 4, at 60 (suggesting that "a key role in keeping agency costs of dispersed shareholdings to a reasonable level is played by the various institutions—public and private, formal and informal—that have arisen in the United States to enforce the fiduciary duties of managers toward their shareholders") (emphasis added).

93. See generally THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 72-78 (1996) (describing underwriting process).

94. See RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 601-04 (4th ed. 1991) (describing various restrictive covenants often found in bond covenants); Macey, *supra* note 71, at 195-96 (arguing that shareholders have found it in their interests to draft covenants that protect bondholders because such covenants can "increase the overall value of the firm by lowering the cost of raising capital from fixed claimants"); Van Der Weide, *supra* note 89, at 45-49; see also *Northwestern Nat'l Ins. Co. v. Donovan*, 916 F.2d 372, 377 (7th Cir. 1990) (arguing that mass-produced form contracts "enable enormous savings in transaction costs"); RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. a (1981) (same).

more difficult, then, the sheer scale of the modern publicly held corporation actually facilitates reliance on market contracting by creditors. To be sure, market contracting is never a costless response to the possibility of opportunism, and this context is no exception. Still, such contracting will be less imperfect where publicly held firms are involved.

Creditors are not the only constituency that will be less vulnerable to opportunism when trading with publicly held corporations: employees, it seems, will often fare better when dealing with such firms. Unlike partnerships or sole proprietorships, for instance, many such firms have national, perpetual reputations developed for marketing purposes. Such reputations function as a sort of performance bond that deters opportunism.⁹⁵ An automotive company named "Ford" that treats its Detroit employees poorly may find itself subject to a formal or informal consumer boycott; it will certainly find it more difficult to hire new employees anywhere in the country.⁹⁶ A smaller, privately held firm with little reputational capital can abuse its employees in Detroit and then expand to new markets without penalty.⁹⁷ Thus, employees who make team-specific investments with publicly held firms will have some assurance against opportunism that employees of smaller firms will lack.

Such reputation-based market mechanisms do not always deter opportunism. A large, publicly traded firm may treat its employees poorly despite the negative reputational effects that result. Employees who believe themselves vulnerable to such opportunism are not without recourse, however. Like creditors, they may protect themselves via market contracting. Of course, individuals who work for smaller firms may find the cost of negotiating and enforcing such agreements prohibitive. The law, however, has altered the institutional framework in a way that facilitates the sort of market contracting that can deter opportunism. For instance, common law

95. Epstein, *supra* note 85, at 967-68; see also Benjamin Klein & Keith Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 618-25 (1981) (arguing that reputation can serve as a performance bond that deters opportunism).

96. In recent memory, several major firms, including Coors, Texaco, and Coca-Cola, have suffered in the marketplace as a result of purportedly unfair employment practices.

97. Cf. Ramseyer, *supra* note 91, at 96-97 (suggesting that small firms with little reputational capital can behave opportunistically without suffering a market sanction).

background rules facilitate the negotiation and enforcement of standard employment contracts, thus reducing the transaction costs associated with the risk of opportunism.⁹⁸ Moreover, the institution of collective bargaining can attenuate such costs. By empowering an agent to write and enforce one contract on behalf of thousands of workers, unionization can spread the fixed costs of negotiation and enforcement, thus making market contracting a more meaningful option for some employees.⁹⁹ To be sure, not all publicly held firms are unionized. Still, given the fixed costs of organizing a bargaining unit, larger firms are far more likely to be organized than smaller ones. Moreover, the absence of unionization may in some cases indicate that employees do not think themselves vulnerable to opportunism.¹⁰⁰ While collective bargaining or other forms of standard contracting will not deter all opportunism directed at employees, these mechanisms will deter some such behavior, particularly that directed at employees of large, publicly held firms. Such mechanisms, supported by contract law and other background

98. See RESTATEMENT (SECOND) OF CONTRACTS § 211 (1981) (allowing enforcement of form contracts if terms are within reasonable expectations of the parties); Coase, *supra* note 86, at 717-18 (explaining that a state can lower transaction costs by altering the institutional framework); Meese, *supra* note 86, at 71-73 (arguing that section 211 and related doctrines can reduce the costs of precontractual opportunism); *id.* at 74-77 (arguing that good faith covenant implied in all contracts can reduce the costs of post-contractual opportunism).

99. Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 294 (1980) (concluding that labor representation on boards may not be necessary because "there may be other market-induced institutions, for example, unions, that more effectively monitor managers on behalf of specific factors"); Benjamin Klein et al., *Vertical Integration, Appropriate Rents, and the Competitive Contracting Process*, 21 J.L. & Econ. 297, 315 (1978) ("When . . . employees may be opportunistically appropriated by the firm, implicit and explicit long-term contracts are also used to prevent such behavior. Because of economies of scale in monitoring and enforcing such contracts, unions may arise as a contract cost-reducing institution for employees with investments in specific human capital."); Douglas L. Leslie, *Labor Bargaining Units*, 70 VA. L. REV. 353, 356-57 (1984) (arguing that unions can achieve collective goods for their members, including detailed employment contracts, that individuals would not rationally negotiate on their own); see also WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 313 (arguing that employees do not need representation on a public corporation's board of directors because they can rely on collective bargaining to devise governance structures that minimize the costs of opportunism); Macey, *supra* note 90, at 192 (stating that employees can thwart opportunism via collective bargaining).

100. See J. Hoult Verkerke, *An Empirical Perspective on Indefinite Term Employment Contracts: Resolving the Just Cause Debate*, 1995 WIS. L. REV. 837, 892-93 (arguing that workers with little taste for contractual protection may self-select away from unionized firms).

rules, make up an institutional framework that obviates the necessity of altering corporate law to provide for a mediating hierarch model of governance.¹⁰¹

It should be noted that there is one constituency that may face a *greater* risk of opportunism in publicly held firms, namely, shareholders. As noted earlier, the defining characteristic of the publicly held corporation is the relative dispersion of equity holders. Unlike law firm partners, for instance, who are in a position to monitor their associate-employees (and fellow partners) seven days per week, those who supply general-use capital to public corporations cannot practicably oversee the activities of the managers who employ their capital, and thus face a special risk of opportunism. Moreover, unlike partners in a law firm, each of whom can take a portion of their (human) capital elsewhere, shareholders' entire investments are perpetually locked into the firm, and thus especially vulnerable to opportunism.¹⁰² Finally, market contracting will fall far short as a means of protecting shareholders against opportunism.¹⁰³ As a result, Oliver

101. See *supra* note 86 and accompanying text (legal rules create a framework that can lower transaction costs).

102. To be sure, any single shareholder can sell his or her shares at any time, thus recovering a portion of the investment. Nevertheless, if opportunism induces all shareholders to sell their stock simultaneously, share prices will plummet. Thus, because opportunism in this context involves behavior that inflicts harm on shareholders *as a class*, shareholders are effectively locked into their investments. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 304 ("Although a well-developed market in shares permits individual stockholders to terminate ownership easily by selling their shares, it does not follow that stockholders as a group have a limited stake in the firm. What is available to individual stockholders may be unavailable to stockholders in the aggregate."); see also HANSMANN, *supra* note 4, at 56 (individuals who supply long-term capital to a firm are thereby "locked-in" and vulnerable to opportunism).

103. See HANSMANN, *supra* note 4, at 55; WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 305 ("Stockholders are also unique in that their investments are not associated with particular assets. The diffuse character of their investments puts shareholders at an enormous disadvantage in crafting the kind of bilateral safeguards [necessary to deter opportunism]. Given the enormous variety, the usual strictures of comprehensive ex ante contracting apply here in superlative degree."); see also HANSMANN, *supra* note 4, at 12 (arguing that those who hold residual claims cannot exercise control over agents by contract because "the essence of what we term control is precisely the authority to determine those aspects of firm policy that, because of high [bargaining] costs or imperfect foresight cannot be specified ex ante in a contract but must be left to the discretion of those to whom authority is granted"); Van Der Weide, *supra* note 89, at 36 ("[I]n order for shareholders to safeguard their investment, they must maintain positive control over a panoply of corporate decisions.

Williamson, the leading exponent of transaction cost economics, has concluded that shareholders in publicly held firms "bear a unique relation to the firm"¹⁰⁴ that renders them more vulnerable to opportunism than any other constituency.¹⁰⁵ According to Professor Williamson, then, the law of public corporations can minimize transaction costs by adopting a single-owner approach, allowing nonshareholder constituencies to rely on market mechanisms or explicit contracting for protection against opportunism.¹⁰⁶

Blair and Stout do not mention Professor Williamson's argument, and thus make no attempt to rebut it.¹⁰⁷ Instead, they suggest that shareholders will face a *lower* risk of opportunism under a mediating hierarchy model of firm governance than under a single-owner approach.¹⁰⁸ This assertion, however, is difficult to accept. Directors who act as mediating hierarchs will have no more authority over nonshareholder constituencies than directors who act as shareholder agents. As a result, they would be no better able to protect shareholders from opportunism than would directors of a single-owner firm. If, for instance, a union opportunistically seeks increased wages by threatening strikes against strategic plants, mediating hierarchs could do nothing in response except, perhaps, give in. Ford's Board of Directors cannot order members of the United Auto Workers back to work, even if corporate law treats these directors as mediating hierarchs. Adoption of a mediating hierarchy model, then, will not protect shareholders from opportunism.

The assertion that shareholders of publicly held corporations face a special risk of opportunism that in part justifies the shareholder

The vast number of relevant contingencies renders contracting impossible.").

104. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 304.

105. See HANSMANN, *supra* note 4, at 56; WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 304.

106. See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 302-11; *see also* HANSMANN, *supra* note 4, at 21 (noting that "all other things equal, costs will be minimized if ownership is assigned to the class of patrons for whom the problems of market contracting—that is, the costs of market imperfections—are most severe").

107. I do not mean to suggest that Blair and Stout have ignored Professor Williamson's work. To the contrary, they rely on other arguments made by Professor Williamson in the same book. *See, e.g.*, Blair & Stout, *supra* note 9, at 279, n.70 (citing WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 249).

108. *See id.* at 275-79.

primacy norm may seem inconsistent with the argument, often made by proponents of the principal-agent account, that various market mechanisms align the interests of shareholders and managers, thus reducing the agency costs that would otherwise attend the formation of a public corporation.¹⁰⁹ Yet, any such inconsistency is only apparent. Market mechanisms and the legal rules that support them need not arise exogenously, independent of the needs of market actors. Instead, the various mechanisms that align the interests of shareholders and managers, all of which appear dependent on the shareholder primacy norm, may be entirely endogenous, having arisen *in response to* the threat of opportunism that shareholders would otherwise face.¹¹⁰ Take, as an example, the market for corporate control, often viewed as an important mechanism for deterring management opportunism towards shareholders.¹¹¹ This mechanism depends upon a combination of markets (stock exchanges) and public law—the (default) rule that common shares, and only common shares, come with one vote each in elections of the Board of Directors.¹¹² Stock exchanges, of course, do not exist in a vacuum; they arise to

109. See *infra* notes 180-87 and accompanying text. Indeed, one author has defended the shareholder primacy norm based in part on an assertion that such mechanisms do a poor job aligning the interest of shareholders and managers. See Van Der Weide, *supra* note 89, at 69-72. As shown in the text, however, one need not believe that market mechanisms are relatively ineffective to embrace the shareholder primacy norm.

110. See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 306 (arguing that the institution of “the board of directors ... arises endogenously, as a means by which to safeguard the investments of those [shareholders] who face a diffuse but significant risk of expropriation”).

111. See, e.g., EASTERBROOK & FISCHER, *supra* note 4, at 171-74; Butler, *supra* note 26, at 111-13.

112. The “one share, one vote” rule is not immutable, but instead a product of legislative or firm choice. German corporations, for instance, generally prohibit any shareholder from voting more than five percent of a firm’s shares. See Jayne Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135, 1138 n.14 (1991) (noting existence of German “rules prohibiting shareholders with more than five or ten percent of a company’s equity from voting the excess over that percentage”); William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT’L L. 213, 237 n.71 (1999) (discussing recent German reforms making it more difficult for institutions to vote large blocks of common shares); Merritt B. Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities*, 97 MICH. L. REV. 696, 759 n.135 (1999) (reporting German judicial nullification of shareholder vote to repeal bylaw placing five percent cap on shareholder voting).

facilitate the issuance and trading of securities and adopt rules designed to enhance investor demand for the shares traded.¹¹³ Although a "legal" mechanism, shareholder voting is also endogenous.¹¹⁴ Taken together, these two mechanisms, along with society's toleration for large disparities in wealth, empower a raider to aggregate a majority interest and thus remove the Board of Directors, an institution that some have also characterized as endogenous.¹¹⁵ Far from rebutting claims that shareholders are vulnerable to exploitation, the evolution and survival of these various mechanisms and supporting institutions that attenuate opportunism, all supported by the shareholder primacy norm, reinforce the claim that shareholders are otherwise specially vulnerable to opportunism.¹¹⁶

The surmise that nonshareholder participants in private firms face a greater risk of opportunism on balance than do similar participants in publicly held firms may, at first glance, seem to *bolster* Blair and Stout's assertion that the distinctive features of the public corporation are designed to thwart intra-team opportunism via creation of a mediating hierarch. Perhaps the prescription they have identified is working! Not so fast. The

113. See HANSMANN, *supra* note 4, at 60 (disclosure rules and rigorous accounting standards can reduce agency costs); WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 306 (same). See generally Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997).

114. See HANSMANN, *supra* note 4, at 63 (placing voting control in hands of common shareholders is "neither a necessity nor an accident, but instead the product of design"); Henry Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1430-31 (1964).

115. See DEMSETZ, *supra* note 41, at 231-34 (social tolerance of large wealth disparities allows individuals to amass large blocks of shares and thus to engage in effective monitoring); WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 306 (arguing that the Board of Directors arises endogenously, to oversee management on behalf of shareholders); Coase, *supra* note 86, at 716-18 (changes in institutional arrangements can affect transaction costs and thus alter content of resulting economic activity); Manne, *supra* note 114, at 1430-31; see also Alchian & Demsetz, *supra* note 3, at 788 (noting that residual claimants' ability to aggregate sufficient shares to oust management can reduce the agency costs produced by the separation of ownership from control that characterizes the public corporation).

116. See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 323-34 (arguing that the assignment of single ownership to shareholders arises "not by history but by logic"); see also *infra* notes 119-27 and accompanying text (noting that existence of mechanisms that align the interests of shareholders and directors appears inconsistent with a "mediating hierarch" model of firm governance).

prescription Blair and Stout have identified is not the formation of a public corporation as such, but instead the formation of a public corporation *governed by mediating hierarchs*. Yet, the opportunism-reducing features described above inure to employees and creditors of public corporations *regardless* of whether a firm has adopted a mediating hierarch model of internal governance. That is, for reasons entirely exogenous to governance structure, creditors and employees in private firms face the same or greater risk of opportunism than do similarly situated individuals in publicly held firms.

Thus, creditors and employees who make team-specific investments in enterprises organized as public corporations may face a *reduced* risk of opportunism compared to those who deal with partnerships and closely held corporations, for instance. Moreover, shareholders of publicly-held firms seem to face a *greater* risk of opportunism than owners of private firms. This realization raises a crucial question for Blair and Stout. If departure from a single-owner standard and delegation of authority to mediating hierarchs "works" for public corporations, such a model of firm governance would seem to produce the same or even greater benefits for other firms, where employees and creditors are arguably more vulnerable to opportunism by residual claimants, and residual claimants are less vulnerable, and thus less in need of the protection accorded by a single-owner model. Yet, as Blair and Stout concede, the laws of partnerships, sole proprietorships, and closely held corporations organize team production along a single-owner model, under which the firm is run to maximize the profits of a single individual or class of residual claimants. Moreover, Blair and Stout do not assert that these private firms create unaccountable mediating hierarchs by contract, even when such firms involve specific investments and a high risk of opportunism.

If, as Blair and Stout assume, states generate the rules governing various forms of business organization with a view toward maximizing social wealth, the absence of mediating hierarchs in private firms would seem to rebut their assertion that creation of mediating hierarchs minimizes the transaction costs produced by the spectre of opportunism inherent in the sort of large-scale team

production that characterizes the publicly held corporation.¹¹⁷ Adoption of a single-owner standard minimizes shareholder vulnerability to opportunism by other constituencies, thus reducing the transaction costs of obtaining equity investment. At the same time, these other constituencies can protect themselves from shareholder opportunism via contract or other devices, and the institutional framework has evolved to facilitate reliance on these mechanisms, obviating the need to adjust *corporate* law to implement a mediating hierarch model of governance.¹¹⁸ While not a perfect solution to the risks of opportunism that accompany team-specific investments, the shareholder primacy norm would seem to be the least imperfect.

B. Ownership Costs

To this point we have assumed that nonowner constituents of privately held firms are just as likely to make team-specific investments as their counterparts in larger, publicly held firms. Moreover, we have argued that various attributes of publicly held firms render nonowner constituents of such entities *less* susceptible

117. Perhaps anticipating such an argument, Blair and Stout assert in a footnote that it would be impractical for directors of closely held corporations to operate as mediating hierarchs because they are directly accountable to the majority shareholder. Blair & Stout, *supra* note 9, at 302 n.136. This argument assumes that various market mechanisms do not render directors accountable to shareholders in public corporations as well. See *infra* notes 180-81 and accompanying text (summarizing arguments by principal-agent theorists that market forces align the interests of shareholders and directors). Moreover, the argument simply begs the question of why states allow majority shareholders to dictate the selection of directors in closely held firms. If a mediating hierarch approach were efficient, states could depart from the rule of one share, one vote, or simply allow directors to appoint their successors. Indeed, Blair and Stout assert that the right of shareholders to elect directors in public corporations is illusory; directors, they say, in fact control the election process. Blair & Stout, *supra* note 9, at 310-11. Thus, states could implement a mediating hierarch model for closely held firms by providing that the founding shareholders would choose directors by unanimous consent, and that directors would subsequently appoint their successors. Cf. Mitchell, *supra* note 19, at 1302-03 (arguing that states should constitute directors as mediators by abolishing shareholder voting for directors and empowering directors to appoint their successors). In the alternative, states could limit the number of votes that shareholders could cast. See *supra* note 112 (discussing such limitations in German corporations). The failure of states to adopt such rules governing the selection of directors suggests that a mediating hierarch approach to governing closely held corporations is less efficient than a single-owner model.

118. WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 3, at 302-11.

to opportunism in the first instance and better able to protect themselves from such conduct via market contracting. Like Blair and Stout, however, we have offered no concrete empirical evidence to support these assertions. Thus, the argument here that a public corporation organized along a single-owner model involves lower transaction costs than private firms may not convince scholars otherwise inclined to embrace the Blair and Stout thesis.

At any rate, proof that public corporations involve lower transaction costs than their private counterparts does not by itself establish the superiority of single-owner firms in either context. While Blair and Stout have conceded that a single-owner model is the most efficient approach for private firms, this concession may be unwarranted. After all, Blair and Stout have not considered the possibility that such firms themselves often involve team-specific investment by various constituencies. Moreover, Blair and Stout have suggested that adoption of a mediating hierarch approach to governance would be unworkable for single-owner firms such as closely held corporations.¹¹⁹

Put another way, the analysis offered thus far may simply call attention to the fact that the threat of opportunism abounds in all sorts of firms, public or private. Perhaps a mediating hierarch approach to firm governance is theoretically superior for both public *and* private firms, only workable for the former. Indeed, it seems hard to dispute the assertion that a director who sets out to maximize the joint welfare of the team will, in theory at least, take steps that minimize the cost of transacting. Thus, proof that

119. See Blair & Stout, *supra* note 9, at 303 n.136 (arguing that directors of closely held corporations cannot act as mediating hierarchs because they are beholden to majority-shareholders); see also *supra* note 117 (arguing that states could provide for mediating hierarch approach in closely held firms by allowing founding shareholders to appoint directors and empowering directors to appoint their successors). One may add an additional argument supporting Blair and Stout's assertion that a mediating hierarch approach is unworkable for private firms. To the extent that 1) private firms are relatively small, and 2) the cost of a mediating hierarch model of governance is in part fixed, such a system will entail a higher cost per unit of output where private firms are concerned. This argument provides only partial support for Blair and Stout's thesis, however. Many closely held corporations, for example, operate at the same or greater scale as some publicly held corporations. See *supra* note 80 (listing various large closely held corporations). The absence of a mediating hierarch system in these firms cannot be explained by the cost of such arrangements.

publicly held firms involve lower transaction costs than private firms could be entirely consistent with Blair and Stout's conclusion that a mediating hierarch approach can minimize these costs in both sorts of firm. Ultimately, however, the case against the mediating hierarch model of corporate governance does not necessarily depend upon proof that a single-owner approach can produce lower transaction costs than a mediating hierarch model. Instead, there would appear to be an independent theoretical objection to the adoption of a mediating hierarch form of governance.

According to Blair and Stout, a mediating hierarch approach to corporate governance will minimize the transaction costs of inducing team-specific investment and thus maximize social welfare. Yet, even if one accepts the numerous assumptions on which this assertion is based, the statement is nevertheless a nonsequitur. The mere fact that a governance structure minimizes the cost of transacting in this sense does not establish that it is preferable to other structures. Instead, as some scholars have argued, there is a second cost to consider, namely, the so-called cost of ownership.¹²⁰ More precisely, any particular assignment of control rights and entitlement to a firm's residual product entails unique costs over and above the transaction costs that attend coordination of the firm's various inputs.¹²¹ Assigning ownership and control rights to dispersed shareholders, for instance, will engender various monitoring costs.¹²² An efficient governance structure will do more than minimize the costs of transacting; it will instead minimize the sum of transaction *and* ownership costs.¹²³

Blair and Stout's analysis focuses exclusively on the transaction cost implications of alternative institutional arrangements; they do not consider the relative costs of ownership produced by single-owner and mediating hierarch approaches, respectively. As shown

120. See HANSMANN, *supra* note 4, at 35-49; Van Der Weide, *supra* note 89, at 34-35, 36-39.

121. HANSMANN, *supra* note 4, at 19-20 (distinguishing between "ownership costs" and transaction costs).

122. *Id.* at 57-62.

123. *Id.* at 21-22.

below, a mediating hierarch model of corporate governance would entail substantial ownership costs over and above those associated with a single-owner approach that assigns common shareholders an exclusive property right in the firm's residual product.

As an initial matter, adoption of a mediating hierarch model would cause firms to forgo one of the principal benefits of the corporate form—agent expertise. Almost by definition, directors who are neutral mediating hierarchs will lack the specialized knowledge and experience possessed by the corporation's officers and managers, some of whom currently serve as directors in publicly held firms.¹²⁴ Blair and Stout admit as much, even arguing at one point that the very incompetence of mediating hierarchs will encourage various constituencies to "get along," lest these directors actually assert control over a firm's affairs.¹²⁵ Thus, even if vesting control over a firm in mediating hierarchs could reduce somewhat the possibility of opportunism and thus lower transaction costs, any such improvement would come at the expense of the gains that would otherwise be realized by vesting *de facto* control of the firm in full-time, specialist managers.¹²⁶

There is, however, a more fundamental problem with the mediating hierarch model. Although Blair and Stout have told a coherent story about how such a model *can* encourage firm-specific investment and thus enhance the firm's total product, they have failed to describe any plausible mechanism that will encourage

124. See *infra* notes 285-90 and accompanying text (summarizing evidence suggesting that inside directors usually exercise *de facto* control over publicly held corporations).

125. Blair & Stout, *supra* note 9, at 282 ("[T]he existence of a mediating hierarchy may heighten incentives for team members to work out conflicts among themselves because the alternative is kicking the problem upstairs to a disinterested—but potentially erratic or ill-informed—hierarch.").

126. Cf. EASTERBROOK & FISCHER, *supra* note 4, at 11; see also *infra* notes 285-90 and accompanying text (showing that most publicly held corporations are under *de facto* control of inside directors). To be sure, Blair and Stout make it clear that the mediating hierarchs they envision will not be involved in day-to-day management of the firm's affairs. Blair & Stout, *supra* note 9, at 282 ("[B]y suggesting that directors serve at the top of the pyramid of authority that comprises the public corporation, the mediating hierarchy model does not imply that directors actually manage the corporation on a day-to-day basis."). Nevertheless, they do contemplate that the directors they envision will choose and supervise managers with sufficient care and attention to deter opportunism that might be directed at any constituency of the firm that has made team-specific investments. Hierarchs with this much latitude over a firm's affairs will have numerous opportunities to make poor decisions.

directors who act as mediating hierarchs to pursue their duties in a conscientious manner. Such hierarchs would not hold residual claims; nor would they be legally accountable to anyone who does.¹²⁷ Moreover, Blair and Stout have not identified any legal or market mechanisms that cause mediating hierarchs to maximize the welfare of the team. Indeed, as Blair and Stout see things, the greatest virtue possessed by such hierarchs is their independence from any such influence.

Blair and Stout do claim that directors will have an interest in cultivating a reputation for being "good" directors: such a reputation, it is said, will help directors retain their current positions and obtain others.¹²⁸ This assertion, however, simply begs the key question: what (if anything) encourages those who nominate and hire directors—other directors—to define as "good" a director who maximizes the product of the team, instead of the product available to shareholders, or, for that matter the product available to directors?¹²⁹ Absent some independent mechanism that induces directors to internalize the residual product of the team they supervise, this argument seems entirely circular.¹³⁰

Blair and Stout also assert that "corporate cultural norms of fairness and trust . . . may work to encourage directors to serve their firms."¹³¹ Blair and Stout do not explain how such norms actually arise; nor do they offer any evidence that they are sufficiently pervasive to induce directors to pursue with diligence the welfare of the teams they supervise, instead of the welfare of shareholders as such. Moreover, they do not explain how such norms can overcome the market mechanisms that concededly cause management to pursue the interests of shareholders.¹³²

127. Such hierarchs would of course be subject to derivative suits by shareholders. However, as Blair and Stout themselves argue, the threat of such suits has little impact on directors' conduct.

128. Blair & Stout, *supra* note 9, at 315.

129. See *id.* at 310-11 (contending that directors exercise de facto control over process of nomination and selection of their successors).

130. Blair and Stout also suggest that corporate law "encourages directors to serve their firms' interests by severely limiting their abilities to serve their own." *Id.* at 315. Preventing directors from pursuing their own interest, however, does not encourage them to pursue the interests of the team.

131. *Id.* at 316 (emphasis added).

132. See *infra* notes 180-84 and accompanying text (describing various market

To be sure, a regime that divided the right to a firm's residual among numerous constituencies and allowed directors to distribute the residual as they saw fit would provide various constituencies with the incentives to monitor directors to ensure that these hierarchs are acting in *their* particular interest. More precisely, each constituency would presumably pressure hierarchs to maximize the amount of residual distributed to *it*. However, because no constituency would be entitled to any particular share of the residual, none would have the incentive or the ability to monitor directors' actions as they relate to the *joint* product of the entire team. Because the fruits of this monitoring would become common property, no constituency could capture more than a fraction of the benefits of such monitoring, and efforts to produce such monitoring would be beset by free riding.¹³³ What course unaccountable directors actually would take in these circumstances is anybody's guess.

Various constituencies could also share information and bargain among themselves, agreeing to urge on directors the actions they believed to be in their collective interests. In the absence of bargaining and information costs, such continual negotiation would maximize the production of the team.¹³⁴ By its nature, however, a mediating hierarchy model of governance ensures that the costs of such bargaining would be exceedingly high.¹³⁵ Each constituency would have to gather information about the effect of various corporate actions on its members, and constituencies would have to

mechanisms that induce directors to act in the interest of shareholders); see also Blair & Stout, *supra* note 9, at 327-28 & n.207 (expressing concern about purportedly recent developments that have caused managers to pursue shareholder value exclusively).

133. Demsetz, *supra* note 68, at 356 ("Under the communal property system the maximization of the value of communal property rights will take place without regard to many costs, because the owner of a communal right cannot exclude others from enjoying the fruit of his efforts.")

134. Cf. Coase, *supra* note 42, *passim*.

135. Armen A. Alchian & Harold Demsetz, *The Property Right Paradigm*, 33 J. ECON. HIST. 16, 22 (1973) ("If the cost of transactions is not negligible, then an alteration in the identity of right owners can have allocative effects because negotiations toward a unique utilization of resources may be inhibited by positive transaction costs. The most important effect of alterations in institutional arrangements may well be the impact of such reorganizations on the cost of transacting."); see also *id.* at 27-28 (stating that cost of transacting is a function of background legal rules and the assignment of rights); Coase, *supra* note 86, at 717-18 (same).

come to agreement about the collective effect of various possible courses of action. Moreover, "collective" recommendations would require unanimous consent, thus raising the possibility that individual constituencies could "hold out," seeking to appropriate a greater share of the team's joint product for themselves.¹³⁶

Thus, even if adoption of a mediating hierarch model of governance could theoretically reduce the transaction costs associated with team-specific investment, any such benefit would come at a high cost: control of the firm by disinterested individuals with no apparent incentive to maximize the welfare of the team. Such hierarchs would find it very difficult in practice to convince constituents that they planned to maximize the welfare of the team. Therefore, such hierarchs could not make credible commitments to protect various constituencies from opportunism.¹³⁷ Without such credibility, a mediating hierarch model of corporate governance could not reduce the transaction costs of inducing firm-specific investment. If anything, this state of affairs would increase such costs, as each constituency would now have to fear opportunism from all constituencies, and not just from shareholders. The shareholder primacy norm, of course, avoids these costs, by assigning a property right in the firm's residual to a single constituency, and allowing expert agents of that constituency to negotiate individually with other constituencies in a setting of relatively low bargaining costs. In such a setting, these agents will have the incentive to craft a nexus of agreements that induce team-specific investment and maximize the team's joint welfare.¹³⁸

It should be noted that the costs of ownership produced by departure from the shareholder primacy norm would afflict all corporate activities, not just those that relate to possible

136. Cf. Epstein, *supra* note 42, at 559-61 (rules requiring consent of all parties affected by a decision raise the prospect of holdouts and result in high bargaining costs and possible deadlock).

137. See *supra* notes 125-30 and accompanying text (describing Blair and Stout's assertion that the mediating hierarch model empowers firms to make credible commitments to refrain from opportunism).

138. Cf. Epstein, *supra* note 42, at 556-57; Alan J. Meese, *Antitrust Balancing In A (Near) Coasean World: The Case of Franchise Tying Contracts*, 95 MICH. L. REV. 111, 132-35 (1996) (where bargaining costs are low, a single owner of franchise trademark will draft franchise contract that includes provisions minimizing the costs of opportunism).

opportunism. The mediating hierarchs that Blair and Stout envision will have ultimate authority over the entire range of corporate decisions, most of which involve constituencies that have not made team-specific investments or do not involve any conflict among those constituencies that have. Indeed, as Blair and Stout themselves concede, the interests of shareholders are usually aligned with the interests of other constituencies, thus suggesting that, in most cases, decisions that maximize share value will also maximize the welfare of the team.¹³⁹ Thus, whatever isolated benefits that adoption of a mediating hierarch model of governance might produce will be outweighed by the generalized efficiency losses generated by such a regime.

Indeed, Blair and Stout's proposal to replace the shareholder primacy norm with a mediating hierarch approach violates a central tenet of the team production theory of the firm on which they base their proposal. The team production theory, after all, rests on a realization that someone must monitor the team to maximize its output. Once such a monitor exists, a natural question arises: "Who will monitor the monitor?"¹⁴⁰ Alchian and Demsetz posed this very question, and the solution they proposed is straightforward: there is no need to monitor the monitor if he or she possesses a property right to the team's residual product and can sell that right and associated control if necessary to someone who is able to do a better job.¹⁴¹ In these circumstances, it might be said, the monitor will take care of itself. In fact, Alchian and Demsetz expressly noted that, by uniting residual claims with votes, corporate law provides shareholders with the incentive and ability to monitor and replace managers who do not maximize the team's net product.¹⁴² In contrast, Blair and Stout deprive shareholders of

139. See Blair & Stout, *supra* note 9, at 313-14; see also EASTERBROOK & FISCHEL, *supra* note 4, at 38 ("[M]aximizing profits for equity investors assists the other 'constituencies' automatically. The participants in the venture play complementary rather than antagonistic roles.").

140. Alchian & Demsetz, *supra* note 3, at 782.

141. See *id.* at 782-83; *id.* at 794 (concluding that "the essence of a classical business firm" includes a single owner who "holds the residual claim" and "has the right to sell his central contractual status").

142. *Id.* at 788; see also DEMSETZ, *supra* note 41, at 231-33 (arguing that ability of shareholders to amass a large block of shares can facilitate shareholder monitoring of management).

any meaningful property right in the firm's residual, thus leaving their monitor, the mediating hierarch, free from effective oversight. They thus leave unanswered the central question: Who will monitor the monitor?

Adoption of the shareholder primacy norm does not require directors to "ruthlessly pursue shareholders' interests at the expense of employees, creditors, or other team members."¹⁴³ To the contrary, directors may serve shareholder interests best by *refraining* from opportunistic conduct or providing credible guarantees that such behavior will not occur in the future.¹⁴⁴ Managers bargaining on behalf of a single owner—shareholders—will act as if they internalize the entire residual to which shareholders are entitled. Thus, these managers will internalize the benefits of inducing team-specific investment. They will also internalize the costs—in the form of higher wages, unfavorable credit terms, and the like—that flow from a failure to provide credible commitments that the firm will not exploit such investments.¹⁴⁵ Because the cost of bargaining in such a setting is relatively low, managers that hope to maximize shareholder returns by inducing various constituencies to make firm-specific investments will have no choice but to offer assurances that the firm will refrain from opportunistic exploitation of these investments.¹⁴⁶ Such assurances can take the form of explicit contracts, such as collective bargaining agreements or bond covenants.¹⁴⁷ They may also consist of less formal mechanisms, such

143. Blair & Stout, *supra* note 9, at 280.

144. *Cf. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985) (management may consider interests of nonshareholder constituencies when necessary to advance the long-term interests of shareholders).

145. See generally WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 32-35 (buyer that fails to provide seller adequate assurance against opportunism will pay higher price for inputs); Alan J. Meese, *Price Theory and Vertical Restraints: A Misunderstood Relation*, 45 UCLA L. REV. 143, 187 (1997) (manufacturer will charge lower price to dealer that provides credible assurances against opportunism).

146. See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 303 (firms can pay lower wages if they provide workers with assurances against opportunism); Van Der Weide, *supra* note 89, at 85 ("Directors and officers should consider the interests of all stakeholders as they maximize share value. Maintaining good relations with creditors, suppliers, customers, and workers are all important parts of maximizing firm profitability.").

147. See *Revlon*, 506 A.2d at 173; WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 307, 313.

as the creation of hostages that ensure that the firm suffers a de facto penalty if management refuses to honor a constituency's expectations.¹⁴⁸ A large manufacturing concern, for instance, may make investments that are only useful in a particular location as a means of protecting workers or the local community against the possibility that the firm will unexpectedly move its operations overseas.¹⁴⁹ By vesting shareholders with an exclusive right to a corporation's residual, then, the principal-agent model facilitates adoption of the sort of mechanisms that can reduce the risk of opportunism and thus minimize the transaction costs associated with inducing team-specific investment.

Ultimately, Blair and Stout's project would appear to be a quintessential application of what some principal-agent theorists have called the Nirvana Fallacy.¹⁵⁰ Emphasizing the imperfections of a principal-agent model, Blair and Stout have offered an alternative that, *in theory*, could obviate the model's perceived shortcomings. Yet, the question is not whether a theoretical model bests a real-world alternative. The question is instead how the two models compare in the real world.¹⁵¹ In the real world, it seems, the principal-agent model is economically superior to a mediating hierarchy approach.

DELAWARE'S EMBRACE OF THE PRINCIPAL-AGENT MODEL

It would appear that the principal-agent conception of the public corporation is a superior economic arrangement to the mediating

148. See generally Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983).

149. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 310 (suggesting that communities can protect themselves against opportunism by insisting that firms "make specialized investments").

150. Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1272 (1982); see also Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J.L. & ECON. 1, 1 (1969) ("In practice, those who adopt the nirvana viewpoint seek to discover discrepancies between the ideal and the real and if discrepancies are found, they deduce that the real is inefficient.").

151. Fischel, *supra* note 150, at 1272 ("Those who purport to discover discrepancies between an ideal norm and existing imperfect institutional arrangements and then conclude that existing arrangements should be displaced, commit the nirvana fallacy well known in economic literature.").

hierarchy approach that Blair and Stout support. Theoretical arguments to one side, however, one could argue that the "proof is in the pudding," i.e., in what type of regimes states have actually adopted. If one posits that states generally adopt efficient bodies of corporate law, and if states have, in fact, adopted corporate law that reflects a mediating hierarchy approach to firm governance, then it would be difficult to dispute Blair and Stout's thesis.

Not surprisingly, then, Blair and Stout claim that the mediating hierarchy theory of the public corporation is consistent with the content of corporate law, in particular, the various doctrines governing the authority of directors and their duties to shareholders and other constituents of the firm.¹⁵² They sensibly focus on the law of Delaware, a state with powerful incentives to promulgate wealth-maximizing corporate law.¹⁵³ At the same time, Blair and Stout argue that the law of Delaware is inconsistent with the principal-agent view of the director-shareholder relationship and thus the shareholder primacy norm.¹⁵⁴ In so doing, Blair and Stout reject the contrary assertion by numerous scholars, some of whom share their view that directors *should* act as mediators between different constituencies.¹⁵⁵

152. Blair & Stout, *supra* note 9, at 287-319.

153. ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 37-44 (1993). It should be noted that some scholars believe that Delaware does not possess sufficient incentives to promulgate efficient corporate law. *E.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 498-509 (1987) (arguing that Delaware corporate law is driven in part by pressure from interest groups, including the corporate bar). Blair and Stout assume otherwise, however, and this Essay embraces their position on this point, at least for the sake of argument.

154. Blair & Stout, *supra* note 9, at 290-92.

155. *E.g.*, David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1374 (1993) (noting that "shareholder primacy has served as corporate law's governing norm for much of this century."); Mitchell, *supra* note 19, at 1284 ("At this point in our legal history, there is no serious dispute over the proposition that corporate managers' duties are owed to the stockholders. . . . Thus it seems clear that any suggestions that the law, as currently formulated and applied, permits consideration of non-stockholder interests in any meaningful way can be put to rest."); *see also* DOOLEY, *supra* note 28, at 97 ("[I]t is generally agreed that management's principal fiduciary duty is to maximize the return to the common shareholders."); Smith, *supra* note 7, at 283 (concluding that "[m]odern corporate law scholarship" has reached a consensus that corporate law implements a shareholder primacy norm). *But see* Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 908-33 (1990) (arguing that, at least in the takeover context, the notion of shareholder primacy has been renounced by state legislatures and "meets stern resistance in Delaware's judge-made

As explained below, Blair and Stout's exegesis is unconvincing for several interrelated reasons. First, the doctrines that Blair and Stout describe accurately are at least equally consistent with the principal-agent conception of the public corporation, particularly when one accounts for the fact that various market mechanisms can align the interests of shareholders and directors. Second, some doctrines that Blair and Stout invoke are, on closer inspection, more consistent with the shareholder primacy norm than with a mediating hierarch approach. Third, Blair and Stout ignore certain decisions, most notably, *Smith v. Van Gorkom*,¹⁵⁶ that are flatly inconsistent with their mediating hierarch approach to governance, and are instead consistent with a principal-agent approach. Finally, Blair and Stout offer no explanation for the states' collective refusal to impose a mediating hierarch model of corporate governance in their corporate codes. While such statutes allow corporations to empower directors to function as mediating hierarchs, few firms actually do so, choosing instead to repose de facto control over the firm's affairs in inside directors who themselves have made significant specific investments in the enterprise. Delaware corporate law is entirely consistent with a principal-agent model of governance, and adoption of a mediating hierarch model would require Delaware to alter its corporate law in a variety of ways.

A. Lack of Director Accountability

Blair and Stout invoke a variety of doctrines and decisional law regarding the relationship between shareholders and directors in support of their claim that corporate law regards directors of public corporations as mediating hierarchs. For instance, the authors note that corporate law does not, in fact, treat directors as shareholder agents, but instead regards directors as akin to trustees.¹⁵⁷ Moreover, while shareholders nominally elect directors, Blair and Stout contend that, in practice, directors control the proxy machinery and thus the election process.¹⁵⁸ To be sure, corporate

doctrine").

156. 488 A.2d 858 (Del. 1985).

157. Blair & Stout, *supra* note 9, at 290-92.

158. *Id.* at 310-11.

law uniformly imposes upon directors a duty of care.¹⁵⁹ As Blair and Stout see things, however, this duty is more illusory than real, given the protection accorded director decisions by the business judgment rule.¹⁶⁰ According to Blair and Stout, this device—which immunizes any rational, good-faith decision made with sufficient process—“seriously undermines directors’ accountability to shareholders by virtually insulating directors from claims of lack of care, [and thus] it seems inconsistent with the view that directors are shareholders’ agents.”¹⁶¹ Finally, Blair and Stout assert that decisional law regarding the content of fiduciary duties empowers directors expressly to pursue the interests of other constituencies, even at the expense of shareholders.¹⁶²

Blair and Stout also emphasize important procedural obstacles that hinder shareholder enforcement of whatever fiduciary duties directors might possess.¹⁶³ For instance, before bringing a derivative action, a shareholder must first demand that directors take some action to remedy the purported wrong.¹⁶⁴ Further, even in those cases where demand is initially excused, the board may take control of the litigation by appointing a committee of independent directors, who may decide to terminate the litigation.¹⁶⁵ Finally, even if a shareholder should negotiate these obstacles and recover a judgment against the directors, Blair and Stout point out that any such judgment is paid into the corporate treasury, and not to the shareholders directly.¹⁶⁶

Taken together, these various features of corporate law would seem to place directors beyond the control of shareholders, thus empowering them to act as mediating hierarchs. Indeed, Blair and Stout claim that proponents of the principal-agent conception of the public corporation and shareholder primacy norm are “puzzled” by these various aspects of corporate law, precisely because they confer

159. See generally CLARK, *supra* note 27, § 3.4.

160. Blair & Stout, *supra* note 9, at 299-301.

161. *Id.* at 300.

162. *Id.* at 301-03.

163. *Id.* at 292-97.

164. *Id.* at 294; see also, e.g., *Aronson v. Lewis*, 473 A.2d 805, 809 (Del. 1984).

165. Blair & Stout, *supra* note 9, at 294; see also, e.g., *Zapata Corp. v. Maldonado*, 430 A.2d 779, 781 (Del. 1981); *Auerbach v. Bennett*, 393 N.E.2d 994, 996 (N.Y. 1979).

166. Blair & Stout, *supra* note 9, at 294-95.

so much discretion on directors.¹⁶⁷ Blair and Stout even go so far as to assert that the very existence of the board of directors is itself "puzzling," and only explicable under a mediating hierarch model.¹⁶⁸ However, as shown below, the various doctrines of Delaware law that accord directors significant discretion are in fact quite consistent with the principal-agent conception of the public corporation.

Far from being "puzzled," principal-agent theorists recognize and even applaud many of the very same doctrines that Blair and Stout invoke. Take the existence of the board of directors. As noted earlier, principal-agent theorists contend that shareholders are particularly vulnerable to opportunism at the hands of managers.¹⁶⁹ According to these theorists, the board of directors arises endogenously, as a mechanism to supervise managers on behalf of shareholders, and shareholders alone.¹⁷⁰ The existence of the board of directors, then, is entirely consistent with the principal-agent model.

Principal-agent theorists also praise the business judgment rule.¹⁷¹ Certainly this rule insulates directors from much judicial oversight that could, conceivably, encourage directors to act in shareholder interests. However, in seizing upon this and other aspects of corporate law that appear to empower directors, Blair

167. *Id.* at 319; see also *id.* at 254-55 (suggesting that "several key legal doctrines distinguishing public corporations from other business forms . . . are difficult to reconcile with the principal-agent approach" and that "[t]hese fundamental and otherwise puzzling characteristics of public corporation law can be explained as a response to the team production problem").

168. *Id.* at 251 (describing the board of directors as "that otherwise puzzling institution").

169. See *supra* notes 5-8 and accompanying text.

170. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 3, at 306 (arguing that the institution of "[t]he board of directors . . . arises endogenously, as a means by which to safeguard the investments of those [shareholders] who face a diffuse but significant risk of expropriation").

171. Indeed, Judge Easterbrook and Professor Fischel introduce their pathbreaking book with a promise to explain the vast discretion that corporate law confers on directors:

Why does corporate law allow managers to set the terms under which they will administer corporate assets? Why do courts grant more discretion to self-interested managers than to disinterested regulators? Why do investors entrust such stupendous sums to managers whose acts are essentially unconstrained by legal rules? *We offer answers to these questions, explanations of the economic structure of corporate law.*

EASTERBROOK & FISCHEL, *supra* note 4, at 3-4 (emphasis added).

and Stout have committed a methodological error quite common among corporate law scholars: they have assumed that formal legal constraints are the only mechanism for aligning the interests of shareholders and directors.¹⁷² As principal-agent theorists have long pointed out, however, numerous market mechanisms exist that help align the interests of shareholders and those who run public corporations, mechanisms that help explain the vast discretion corporate law confers on directors.¹⁷³ For instance, directors and managers who fail to maximize profits will suffer in the *labor market*, as they find it difficult to obtain remunerative employment at other firms.¹⁷⁴ Further, corporations that produce high-priced or poor-quality output will be punished in the *product market*, as consumers turn to other firms, thus lowering corporate earnings.¹⁷⁵ If carried to an extreme, such incompetence may spell the death of the firm and, of course, cost managers and directors their jobs.¹⁷⁶ Even if firms stay in business, however, lower corporate earnings

172. Some scholars have traced the origins of this methodological error to Berle and Means. See generally ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932). According to Professor Butler, for instance:

The Berle and Means perspective on the corporation has fostered the view among some legal commentators that corporation law is the only meaningful constraint on managerial behavior. This has led to public policy arguments that place great emphasis on the role of laws in governing the relationship between shareholders and managers. In essence, some commentators have assumed that managers, freed from legal constraints, can abuse shareholders' interests without cost. Corporation law, according to this view, plays a pre-eminent role in maintaining balance in the large corporation characterized by a separation of ownership and control.

Butler, *supra* note 26, at 102; see also Jason Scott Johnston, *The Influence of the Nature of the Firm on the Theory of Corporate Law*, 18 J. CORP. L. 213, 219-29 (1993) (showing that Berle and Means and other realist scholars assumed without proof that corporation law is the only vehicle for reducing agency costs); *id.* at 221 (concluding that this Berle and Means approach "mirrored perfectly the dominant scholarly method adopted by law professors of their own generation and generations to come").

173. E.g., Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1984); see also EASTERBROOK & FISCHEL, *supra* note 4, at 91-97; ROMANO, *supra* note 153, 14-15; RALPH K. WINTER, *GOVERNMENT AND THE CORPORATION*, 7-28 (1978); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 18-44 (1990).

174. E.g., EASTERBROOK & FISCHEL, *supra* note 4, at 91; Butler & Ribstein, *supra* note 173, at 25-27; see also Fama, *supra* note 99, *passim*.

175. EASTERBROOK & FISCHEL, *supra* note 4, at 91; WINTER, *supra* note 173, at 17-18; Butler, *supra* note 26, at 114.

176. EASTERBROOK & FISCHEL, *supra* note 4, at 91.

will likely translate into reduced incomes for managers, who often own significant blocks of the firm's stock or work pursuant to contracts that tie pay to performance via stock options and the like.¹⁷⁷ Finally, firms that underperform will suffer in the *capital market*, as creditors demand higher rates of interest and stockholders see share prices fall.¹⁷⁸ Falling share prices, of course, will evoke the *market for corporate control*, as bidders amass a majority of a firm's common shares and oust incumbent managers.¹⁷⁹

According to principal-agent theorists, these various market mechanisms have evolved to fortify the shareholder primacy norm, protecting shareholders from the sort of manager opportunism that might otherwise flow from the separation of ownership from control.¹⁸⁰ The presence of these mechanisms, it is said, obviates the

177. See Butler & Ribstein, *supra* note 173, at 26-27; Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375, 387-90 (1983) (finding that directors and officers often hold significant blocks of a firm's shares).

178. EASTERBROOK & FISCHER, *supra* note 4, at 4-7; J.A.C. Hetherington, *When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 HOFSTRA L. REV. 183, 186-87 (1979).

179. EASTERBROOK & FISCHER, *supra* note 4, at 171-72; WINTER, *supra* note 173, at 18-20; Butler & Ribstein, *supra* note 173, at 23-25; Hetherington, *supra* note 178, at 186-87; Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 110-20 (1965); see also Alchian & Demsetz, *supra* note 3, at 788 (contending that the market for corporate control can discipline directors and managers who fail to oversee the team efficiently).

180. Easterbrook, *supra* note 173; at 543-70 (collecting and summarizing evidence that various market mechanisms align the interests of shareholders and managers). In their conclusion, Blair and Stout note that market forces can cause directors to act in the interests of shareholders and that "recent[ly]" directors have begun pursuing shareholder interests exclusively. Blair & Stout, *supra* note 9, at 326-27 & n.207. Other scholars disagree with Blair and Stout's assertion that market-induced attention to shareholder interests is a "recent" phenomenon. As one noted economist put it over three decades ago:

Reports of the deliberations of the top levels of management in major American corporations seem to indicate a widespread concern with the performance of the companies' securities. Even in companies which have long refrained from the issue of new stocks and which apparently have no plans for such an issue in the foreseeable future there seems to be a heavy preoccupation with the market's evaluation of the corporation's shares. Whatever the reasons . . . this concern is by itself sufficient to empower the market to oversee the behavior of management. If the businessman is motivated to avoid reductions in the price of his firm's securities and if, in fact, he hopes that those prices will rise rather steadily and dependably with the passage of time, he will be driven to adapt his decisions to this purpose. Behavior which depresses security prices will then conflict with company objectives.

necessity of intrusive judicial review of director (or manager) action; why should courts intrude when markets can do a better job?¹⁸¹ The existence of these mechanisms and the associated shareholder primacy norm also explain why the business judgment rule applies to decisions by nondirector officers, who are members of the team and emphatically not mediating hierarchs.¹⁸² A mediating hierarchy model of firm governance, on the other hand, simply cannot explain or account for such deference to decisions by particular members of the team.

Importantly, principal-agent theorists have argued that the structure of fiduciary duties reflects the relative potency of market mechanisms in various contexts. Where, for instance, market mechanisms work well, courts will and should stay their hand.¹⁸³ Where, on the other hand, such mechanisms will likely be ineffective, as when, for instance, directors are in the final period, judicial review should be more intrusive.¹⁸⁴ Corporate law, of course, tracks these insights.¹⁸⁵

WILLIAM J. BAUMOL, *THE STOCK MARKET AND ECONOMIC EFFICIENCY* 79-80 (1965).

181. See EASTERBROOK & FISCHEL, *supra* note 4, at 93-99; *id.* at 93 ("Behind the business judgment rule lies recognition that investors' wealth would be lower if managers' decisions were routinely subjected to strict judicial review."); see also Butler & Ribstein, *supra* note 173, at 28-32 (arguing that "the fundamentally contractual nature of [managers'] fiduciary duties means that they should be subject to the same presumption in favor of private ordering that applies to other contracts"); Fischel, *supra* note 150, at 1265 (arguing that proponents of legal reform designed to reduce agency costs "have failed to demonstrate the existence of any problem of any kind, whether defined as accountability to shareholders or to society as a whole").

182. See *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971) (stating that the business judgment rule applies to decisions by executive officers); A.L.I., *PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 4.01(c) (1992) (applying business judgment rule to "director or officer"); see also Blair & Stout, *supra* note 9, at 288 (indicating that professional managers are members of the corporate team who often make team-specific investments).

183. EASTERBROOK & FISCHEL, *supra* note 4, at 99.

184. *Id.* at 103:

Duty-of-loyalty problems often involve spectacular, one-shot appropriations, of the "take the money and run" sort, in which subsequent penalties through markets are inadequate. Liability rules are most helpful when other mechanisms fail. A manager on the verge of retirement is not likely to be deterred from wrongdoing by the decline in his future wage. The duty of loyalty supplements market penalties for breach in those situations where market penalties themselves might be insufficient.

185. *E.g.*, *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (articulating heightened standard of judicial review where managers adopt tactics that ward off tender

Principal-agent theorists are not the only scholars who have noticed the role that market mechanisms can play in aligning the interests of shareholders and directors. Indeed, for decades advocates of corporate social responsibility and other opponents of the shareholder primacy norm have argued that market mechanisms are in a sense *too* powerful, that is, force directors to pursue shareholder wealth in a single-minded fashion.¹⁸⁶ Early in their article, Blair and Stout do mention the assertion by principal-agent theorists that market mechanisms constrain directors to act in the interests of shareholders.¹⁸⁷ Their subsequent discussion of Delaware law, however, does not rebut or even allude to this argument.¹⁸⁸ Instead they simply assert, without evidence or

offers); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (same); *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) (absent fraud, conflict of interest, or gross negligence in gathering information, court will not disturb good-faith judgment); *Fliegler v. Lawrence*, 361 A.2d 218, 221 (Del. 1976) (scrutinizing conflict-of-interest transaction for "entire fairness" despite disclosure to and ratification by shareholders).

186. *E.g.*, Hetherington, *supra* note 178, at 185 ("[T]he most persistent complaint about corporate management's behavior by the advocates of corporate responsibility is that in their zealous pursuit of profits corporate managers have engaged in antisocial behavior.") (citing RALPH NADER ET AL., *TAMING THE GIANT CORPORATION* 16-32 (1976)); Mitchell, *supra* note 19, at 1290-91 (arguing that pressure from institutional investors leads to undue director focus on maximizing share prices); *id.* at 1301-17 (arguing that states should adopt reforms that constitute directors as "mediators" among various corporate constituencies); see also Donald E. Schwartz, *Towards New Corporate Goals: Co-existence with Society*, 60 GEO. L.J. 57 (1971); Elliot J. Weiss, *Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse*, 28 UCLA L. REV. 343 (1981).

187. Blair & Stout, *supra* note 9, at 252 (noting the argument that "even though the legal constraints on directors are weak, market constraints ... keep directors focused on maximizing profits and share value"). Moreover, as noted earlier, Blair and Stout lament the fact that "recently," market forces have caused directors to pursue shareholder interests exclusively. See *supra* note 180. Principal-agent theorists, of course, would dispute the assertion that market-induced concern for shareholders is a "recent" phenomenon. *Id.* At any rate, Blair and Stout do not explore the implications of this phenomenon for their assertion that Delaware law reflects a mediating hierarch conception of governance.

188. The argument that various market mechanisms constrain directors and thus obviate the need for intensive judicial review is not at all obscure. Indeed, Judge Easterbrook and Professor Fischel took this position in their pathbreaking work on corporate law. EASTERBROOK & FISCHEL, *supra* note 4, at 94-97 (arguing that market mechanisms obviate the need for intrusive judicial review); cf. Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1392 & n.4 (1992) (asserting that Easterbrook and Fischel's *Economic Structure of Corporate Law* "may be the best book ever written about corporate law"); Johnston, *supra* note 172, at 232 (describing Easterbrook and Fischel's application of the theory of the firm to questions of corporate law as a "great and indeed revolutionary achievement").

argument, that directors are "constrained primarily by their fiduciary duties."¹⁸⁹

Blair and Stout's claim that the relationship between shareholders and directors is best explained by means of a mediating hierarch model does not rest solely upon the laxity of the business judgment rule. As noted above, they also rely heavily upon the various procedural obstacles to seeking relief from directors in a derivative action.¹⁹⁰ These obstacles, they argue, further insulate directors from shareholders, allowing directors to perform their roles as mediating hierarchs.¹⁹¹ Like the business judgment rule, however, each of these doctrines is equally consistent with the principal-agent model, so long as market mechanisms are taken into account.

Consider, for instance, the requirement that shareholders make a demand on directors before instituting litigation on the firm's behalf.¹⁹² Failure to make such a demand ensures dismissal of the litigation, and a board's refusal to accede to such a demand is ordinarily judged under the business judgment rule.¹⁹³ This requirement dates from at least the nineteenth century, when, Blair and Stout concede, courts adhered to a shareholder primacy norm.¹⁹⁴ Moreover, the requirement is not limited to publicly held corporations, but applies equally to those that are closely held.¹⁹⁵ At

189. Blair & Stout, *supra* note 9, at 291.

190. See *supra* notes 163-66 and accompanying text.

191. Blair & Stout, *supra* note 9, at 292-95.

192. Aronson v. Lewis, 473 A.2d 805, 814-15 (Del. 1984).

193. Levine v. Smith, 591 A.2d 194, 212-14 (Del. 1991), *overruled in part on other grounds* by Brehm v. Eisner, 746 A.2d 244 (Del. 2000); Spiegel v. Buntrock, 571 A.2d 767, 777 (Del. 1990).

194. Blair & Stout, *supra* note 9, at 301 & n.127 (citing Koehler v. Black River Falls Iron Co., 67 U.S. (2 Black) 715 (1862)); see also Hawes v. Oakland, 104 U.S. 450 (1881); Smith, *supra* note 7, at 296-304 (demonstrating that nineteenth-century courts adhered to the shareholder primacy norm). Courts apparently believed that the demand requirement was perfectly consistent with this norm.

195. Delaware courts routinely apply the demand requirement in cases involving closely held corporations. *E.g.*, Andreae v. Andreae, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,571, at 92,649 (Del. Ch. 1992); Thorpe v. CERBCO, Inc., 611 A.2d 5, 9 (Del. Ch. 1991). Indeed, the leading Delaware decision regarding the demand requirement ordered the dismissal of an action for failure to make a demand even though the plaintiff had alleged that the defendant directors were controlled by a single individual who owned forty-seven percent of the firm's stock. Aronson, 473 A.2d at 815-16. The court expressly stated that "even proof of majority ownership of a company does not strip the directors of the presumptions of

any rate, the requirement would seem to make perfect sense in light of the separation of function that characterizes the modern public corporation, a separation that principal-agent theorists emphasize.¹⁹⁶ As explained earlier, the separation of ownership from control allows for specialization: shareholders contribute capital and bear risk, while directors and managers bring to bear their superior expertise managing the firm's assets.¹⁹⁷ A cause of action—whether against directors or a supplier who is in breach of contract—is an asset like any other, and thus, principal-agent theorists suggest, properly left to the expertise of directors and management.¹⁹⁸ Not only will these specialists be better equipped than their principals to evaluate the strengths and benefits of such claims, they will also have stronger incentives to do so in a disinterested fashion. For, although market mechanisms align the interests of directors with shareholders, they do little to ensure that, for instance, small shareholders and their attorneys will act in the interest of shareholders as a whole.¹⁹⁹ Indeed, some principal-

independence," with the result that, without more, the demand requirement applies in such circumstances. *Id.* at 815; cf. Blair & Stout, *supra* note 9, at 281 n.74 (defining "private corporation" as including companies "effectively controlled by a single shareholder or group of shareholders").

196. See *supra* notes 26-27 and accompanying text.

197. *Id.*

198. *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263 (1917) (Brandeis, J.) ("Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management . . ."); *Starrels v. First Nat'l Bank of Chicago*, 870 F.2d 1168, 1173 (7th Cir. 1989) (Easterbrook, J., concurring) ("The persuasive rationale for the demand requirement [under Delaware law] is that it allows directors to make a business decision about a business question: whether to invest the time and resources of the corporation in litigation."); *Spiegel*, 571 A.2d at 773 ("The decision to bring a law suit or to refrain from litigating a claim on behalf of a corporation is a decision concerning the management of the corporation."); *EASTERBROOK & FISCHER*, *supra* note 4, at 105-06; Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 522 (1989) ("Obviously, no principled distinction can be drawn between a board's decisions relating to corporate litigation generally and those relating to other business matters. Indeed, a board's decision whether to pursue, settle, or forgo litigation is, at bottom, a business decision . . .").

199. *EASTERBROOK & FISCHER*, *supra* note 4, at 101. Easterbrook and Fischel note that:

Shareholders with tiny holdings can bring derivative actions. Holders of small stakes have little incentive to consider the effect of the action on other shareholders, the supposed beneficiaries who ultimately bear the costs. If the action appears to be a positive net value project because of the possible recovery of attorneys' fees, an attorney will pursue it regardless of its effect on the value

agent theorists have gone so far as to suggest that the derivative suit is an ineffective vehicle for overseeing directors and thus should be abolished.²⁰⁰ Requiring shareholders to submit a corporation's cause of action to directors and abide by their decision makes perfect sense in light of these considerations and is thus consistent with the principal-agent model.

Blair and Stout also place significant weight on the fact that directors are not, as a formal legal matter, shareholder agents, but are instead more akin to trustees.²⁰¹ However, the mere fact that directors are not shareholder agents for legal purposes does not by itself undermine the analytical usefulness of the principal-agent metaphor.²⁰² At any rate, a determination that directors are trustees merely begs the question: "Trustees for whom?" One could, of course, conclude that they are trustees for *shareholders*, as some influential scholars have argued.²⁰³

Of course, litigation to enforce fiduciary duties is not the only legal mechanism that can align the interests of shareholders and

of the firm.

Id.; see also Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J.L. ECON. & ORG. 55, 65 (1991) (concluding that "the principal beneficiaries of cash payouts in shareholder suits are attorneys").

200. See Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1988); see also Butler & Ribstein, *supra* note 173, at 28-32, 53-64 (arguing that corporations should be free to opt out of fiduciary duties).

201. Blair & Stout, *supra* note 9, at 290-92.

202. Cf. THE FEDERALIST NO. 78 (Alexander Hamilton) (relying on principal-agent metaphor to justify judicial review).

203. See A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931) (arguing that directors should be viewed as trustees for *shareholders*); see also BERLE & MEANS, *supra* note 172, at 247-76 (arguing that corporate directors should exercise powers as trustees for *shareholders*); Smith, *supra* note 7, at 301-04 (discussing nineteenth-century case law holding that directors are trustees for *shareholders*). Blair and Stout also point out that courts usually characterize directors' duties as flowing to the *corporation*. Blair & Stout, *supra* note 9, at 293-94. However, other scholars who oppose the shareholder primacy norm have concluded that, in practice, courts have never given any meaning to this distinction. David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 255 ("Delaware jurisprudence has long described management's fiduciary duties as owing to 'the corporation and its shareholders.' The meaning of the distinction (if indeed one was intended) has never been explained."); Mitchell, *supra* note 19, at 1284 ("Although the traditional doctrinal formulation [of fiduciary duties] ... directs those duties to the corporation (either exclusively or in addition to the stockholders), the application of such duties reflects purely a stockholder-centric view.").

directors: shareholders can also vote poorly performing directors out of office. Although Blair and Stout have asserted that shareholder voting is an illusory institution,²⁰⁴ closer analysis suggests that shareholders do, in many cases employ the franchise to affect corporate policy. For while corporate law allows for widely dispersed shareholdings by diversified investors, it also allows individual or institutional investors to obtain significant blocks of a firm's shares, thereby attenuating the sort of free-riding problems that might otherwise preclude effective monitoring.²⁰⁵

Studies confirm that wealthy individuals and institutions hold significant blocks of common shares in the nation's largest publicly held corporations.²⁰⁶ Although such blocks rarely constitute a majority of common shares, rules facilitating the solicitation and exercise of proxies allow for effective collective action.²⁰⁷ This is not to say that voting is always an effective mechanism of corporate governance. Then again, principal-agent theorists have never said that it should be. The whole point of separating ownership from control is to centralize decision-making authority within a body of specialist managers who have ready access to information about the effects of various decisions on the firm's prospects.²⁰⁸ If market

204. See *supra* notes 157-62 and accompanying text.

205. See DEMSETZ, *supra* note 41, at 231-33 (arguing that ability to amass significant blocks of common shares can enhance incentive for effective monitoring and control).

206. E.g., Barnard, *supra* note 112, at 1140-57 (detailing concentration in institutional holdings and rise in institutional activism); Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155, 1156-57 (1985) (finding that, on average, the five largest ownership interests in Fortune 500 corporations collectively controlled twenty-five percent of each firm's outstanding shares); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 447-51 (1991) (describing significant increases in institutional ownership of stock in public corporations).

207. E.g., Randall S. Thomas, *Judicial Review of Defensive Tactics In Proxy Contests: When Is Using A Rights Plan Right?*, 46 VAND. L. REV. 503, 504-05 (1993) ("Proxy contests have reemerged recently as an important part of the market for corporate control. After years of indifference to corporate elections, dissident shareholders have turned once again to the ballot box as a means of removing unwanted management."); see also DEL. CODE ANN. tit. 8, § 220 (1991 & Supp. 2000) (allowing a shareholder to obtain the list of fellow shareholders absent a showing of improper purpose); *Credit Bureau Reports, Inc. v. Credit Bureau of St. Paul, Inc.*, 290 A.2d 691 (Del. 1972) (ruling that a desire to communicate with fellow shareholders as part of a proxy contest is a proper purpose that entitles a shareholder to a shareholder list).

208. See *supra* notes 43-44 and accompanying text.

mechanisms align the interests of shareholders and managers, voting becomes superfluous, a waste of shareholders' and society's time and resources.²⁰⁹ The secondary role of shareholder voting, then, is entirely consistent with the principal-agent conception of the corporation.²¹⁰

This is not to say that principal-agent theorists believe that voting is entirely useless. Like fiduciary duties, voting can serve a "backstop" role, filling in when market mechanisms might be ineffective. Thus, states routinely require votes on so-called "fundamental corporate changes," such as mergers and the like, that occur when directors and managers are in the final period.²¹¹ Moreover, attaching votes to common shares facilitates the operation of the market for corporate control.²¹² The existence and structure of voting, then, seems quite consistent with the principal-agent model of the corporation. Blair and Stout, on the other hand, provide no convincing explanation for the continued existence of a purportedly useless institution.²¹³

209. EASTERBROOK & FISCHEL, *supra* note 4, at 63-89.

210. WINTER, *supra* note 173, at 31 ("It is notorious that the vast majority of shareholders in large corporations do not want the power to interfere in corporate affairs, would not use it if they had it, and do not regard themselves as corporate overseers."); Michael P. Dooley, *Controlling Giant Corporations: The Question of Legitimacy*, in CORPORATE GOVERNANCE: PAST & FUTURE 28, 38 (H. Manne ed., 1982) ("[T]he limited governance role assigned to shareholders is intentional and is, in fact, the genius of the corporate form."); Fischel, *supra* note 150, at 1276-77 (explaining that the modern corporation's genius is that it "enables individuals who have wealth but lack managerial ability to invest while simultaneously allowing professional managers who lack personal wealth to run enterprises. Shareholders would be hurt rather than helped if they were given more power, which no doubt explains why they show no enthusiasm for the constant proposals to increase their role."); Hetherington, *supra* note 178, at 184-88, 190-99.

211. E.g., DEL. CODE ANN. tit. 8, § 242 (1991 & Supp. 2000) (requiring a shareholder vote for an amendment to the certificate of incorporation); *id.* § 251 (requiring a shareholder vote for merger); *id.* § 271 (requiring a shareholder vote for the sale of all or substantially all of a firm's assets); *id.* § 275 (requiring a shareholder vote for dissolution of the firm).

212. See *supra* notes 111-15 and accompanying text; see also EASTERBROOK & FISCHEL, *supra* note 4, at 70-71; Henry G. Manne, *Some Theoretical Aspects of Share Voting: An Essay in Honor of Adolf A. Berle*, 64 COLUM. L. REV. 1427, 1430-31 (1964).

213. Cf. Butler & Ribstein, *supra* note 173, at 25 n.100 ("[T]he mere fact that such voting rights have survived more than fifty years after Berle and Means concluded they were meaningless is of some significance."). Blair and Stout do attempt to reconcile the existence of shareholder voting with their mediating hierarchy theory. Blair & Stout, *supra* note 9, at 276-87. In particular, they argue that *some* member of the team must choose directors, and that shareholders might as well do so because maximizing the value of a firm's stock can benefit other members of the team as well. *Id.* at 277-78. However, if directors are in fact

B. Substantive Content of Directors' Duties

Despite the significant discretion that corporate law accords corporate decision makers, courts do, in some cases, find that directors have breached their duty of care. As noted earlier, Blair and Stout also find support for their thesis in those decisions that do find breaches of fiduciary duties, as well as decisions that purportedly authorize directors explicitly to advance the interests of nonshareholder constituencies at the expense of shareholders. According to Blair and Stout, courts never require directors to pursue shareholder welfare at the expense of others but instead find directors liable only when doing so will advance the interests of shareholders *and* other constituents who have made firm-specific investments.²¹⁴ Thus, even if the presence of market mechanisms could explain lax judicial oversight of shareholders' agents, as well as the relative unimportance of shareholder voting, Blair and Stout assert that the principal-agent model cannot account for the pattern of cases in which courts do, in fact, find that directors have breached their fiduciary duties.

Certainly a director who breaches his or her fiduciary duties will most likely harm more than the firm's shareholders. A director who stands by while managers run a firm into the ground or expose the firm to tremendous liability injures shareholders, creditors, and employees.²¹⁵ Moreover, the damages occasioned by such breaches

best characterized as mediating hierarchs, and not shareholder agents, it would seem to follow that directors should appoint their own successors. See Mitchell, *supra* note 19, at 1302-03 (arguing that directors should be characterized as mediators among various stakeholders and should therefore appoint their own successors). Moreover, if maximizing share value can benefit other constituencies, then it is not clear what is to be gained by a departure from the shareholder primacy norm.

214. Blair & Stout, *supra* note 9, at 289 ("[T]he benefits of such derivative actions inure not just to shareholders, but to *all* stakeholders."); *id.* at 293 ("[S]hareholders are allowed to sue derivatively not just to protect shareholders, but to protect the interests of *all* the members of the coalition that comprises the firm."); *id.* at 298 ("Corporate law only permits shareholders to bring successful derivative claims against directors in circumstances where bringing such claims benefits not only shareholders, but other stakeholders in the coalition as well.") (emphasis omitted).

215. See *In re Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924) (finding a breach of the duty of care where a director failed adequately to supervise two officers who deadlocked on how to run the firm, thus driving it out of business); *In re Caremark Int'l, Inc.*, 698 A.2d 959 (Del. Ch. 1996) (approving settlement of a claim that directors failed to oversee conduct that

are usually paid directly into the corporate treasury, thus generating cash to pay off creditors, be they banks or workers.²¹⁶ This is true regardless of whether the firm is publicly held, however, thus casting doubt on the assertion that a mediating hierarch conception of governance drives such doctrines. At any rate, the fact that a duty owed to shareholders might incidentally benefit others does not by itself extend the duty to other constituencies.²¹⁷ If directors install a legal compliance program that prevents price-fixing and thus saves the firm from treble damages and criminal fines, they incidentally will thereby advance the interests of consumers.²¹⁸ Directors do not owe consumers a duty of care, however.²¹⁹ Thus, even if correct, Blair and Stout's assertion that successful actions against directors benefit all constituencies, while consistent with the mediating hierarch conception of the public corporation, is equally consistent with the principal-agent approach.

At any rate, Blair and Stout have overlooked significant case law, most notably *Smith v. Van Gorkom*²²⁰ that does, in fact, impose liability on directors for failing to advance the interests of shareholders vis-à-vis other constituents and thus falsifies their hypothesis. In *Van Gorkom*, the board of directors recommended, and the shareholders approved, the sale of Trans Union to a friendly bidder for a forty-five percent premium over the market

resulted in firm's conviction for mail fraud and civil liability of \$98 million); *In re Baxter Int'l, Inc.*, 654 A.2d 1268 (Del. Ch. 1995) (considering stockholder derivative actions against directors for failing to prevent employee misconduct that caused the corporation to be suspended from receiving new government contracts).

216. *But see infra* note 228 and accompanying text (describing existence of a direct action in which judgments are paid directly to shareholders).

217. Indeed, two leading proponents of the shareholder primacy norm expressly note that a duty to maximize shareholder profits will incidentally benefit other constituencies. EASTERBROOK & FISCHER, *supra* note 4, at 38 ("[M]aximizing profits for equity investors assists the other 'constituencies' automatically. The participants in the venture play complementary rather than antagonistic roles.").

218. *See* *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963) (considering and rejecting a claim that directors breached their duty of care by failing to root out price-fixing).

219. *Cf. National Consumers Union v. Nat'l Tea Co.*, 302 N.E.2d 118, 121-22 (Ill. App. Ct. 1973) (holding that shareholder who wished to "sensitize" a firm about consumer demands did not state a "proper purpose" entitling her to examine the firm's books and records).

220. 488 A.2d 858 (Del. 1985).

price of the firm's shares.²²¹ The Delaware Supreme Court found that these directors had breached their duty of care by failing to inform themselves adequately before recommending sale of the firm to the bidder.²²² The court held that further study may have revealed that the negotiated purchase price understated the "intrinsic" value of the firm.²²³ Thus, the court remanded the case to the trial court for a determination of the "fair value of the shares represented by the plaintiffs' class, based on the intrinsic value of Trans Union."²²⁴

Many have characterized *Van Gorkom* as the most important Delaware decision in decades,²²⁵ and Delaware courts often cite it as a definitive statement of the content of directors' fiduciary obligations.²²⁶ This watershed decision simply cannot be squared with Blair and Stout's portrayal of Delaware's approach to fiduciary duties. To begin with, the decision was not a derivative action, but instead involved a class action by shareholders in their personal capacity.²²⁷ Moreover, the court made it quite clear that any damages determined by the trial court would be paid directly to the shareholders and not to Trans Union's corporate successor.²²⁸ Most importantly, the whole point of the decision and its progeny is that directors have a fiduciary obligation to obtain the "highest value

221. *Id.* at 864-70.

222. *Id.* at 870-93.

223. *Id.* at 874-78.

224. *Id.* at 893.

225. Patricia A. Daniel, *Recent Developments Concerning the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 VAND. L. REV. 631, 638 (1987) (calling *Van Gorkom* "the most important recent case concerning the duty of care and the business judgment rule"); Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127, 127 (1988) (calling *Van Gorkom* "one of the most important . . . corporate law cases of the decade"); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 1 (1985) ("The Delaware Supreme Court in *Van Gorkom* exploded a bomb."); see also Blair & Stout, *supra* note 9, at 299 & n.121, 300 & nn.122 & 124 (citing *Van Gorkom* for existence and content of duty of care).

226. *E.g.*, *Brehm v. Eisner*, 746 A.2d 244, 259 n.45 (Del. 2000); *Malone v. Brincat*, 722 A.2d 5, 11-12 (Del. 1998); *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1292 n.40 (Del. 1998).

227. *Van Gorkom*, 488 A.2d at 863, 864 & nn.1-3; see also CLARK, *supra* note 27, at 662-64 (analyzing distinction between direct and derivative actions).

228. *Van Gorkom*, 488 A.2d at 893.

reasonably available" for shareholders should directors decide to negotiate and recommend the sale of the company.²²⁹

Recognition of a direct shareholder action to enforce the duty of care as articulated in *Van Gorkom* seems quite inconsistent with the mediating hierarch model. Bidders, after all, have made significant investments generating information about the target, investments that are in large part specific to the firm in question.²³⁰ Moreover, other constituents of the target will, presumably, go to work for or become creditors of any successful bidder. By negotiating the highest price reasonably available for shareholders, then, directors of a target firm allocate the net present value of the firm's residual to shareholders, "at the expense of" the bidder and the target's other constituencies.²³¹ This course of action is flatly inconsistent with the duties of mediating hierarchs as Blair and Stout conceive them.²³² In fact, some scholars have argued that seeking high prices for shareholders in this situation is a quintessential example of opportunism vis-à-vis other

229. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993); *Van Gorkom*, 488 A.2d at 893.

230. *E.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982).

231. EASTERBROOK & FISCHEL, *supra* note 4, at 189 (noting that resistance to tender offers merely transfers wealth from bidder to target shareholders).

It should be noted that many principal-agent theorists have criticized *Van Gorkom* quite harshly. *E.g.*, Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1455 (1985) (calling *Van Gorkom* "one of the worst decisions in the history of corporate law"). These critics do not, however, take issue with *Van Gorkom's* assumption that directors owe a fiduciary duty to shareholders *qua* shareholders. Instead, they argue that market mechanisms will ordinarily induce directors to act in shareholder interests, and that courts should not second-guess director decisions to recommend a sale of the firm at a substantial premium above its market value. *Id.* at 1439-51.

232. See *supra* notes 9-17 and accompanying text (describing duty of mediating hierarchs). Indeed, Blair and Stout themselves state that paying damages caused by breaches of fiduciary duty directly to shareholders would be inconsistent with their mediating hierarch theory. Blair & Stout, *supra* note 9, at 295 ("If shareholders could be the direct recipients of damages payments in derivative cases, the net effect would be similar to a dividend payment: Shareholders as a group would become wealthier at the expense of the corporate entity. This sort of wealth transfer usually harms creditors, employees, and other stakeholders in the corporation."). While this statement refers only to derivative actions, its logic applies with equal force to direct actions. Both sorts of action, after all, enforce the very same duty of care.

constituencies.²³³ Shareholder primacy is the linchpin of *Van Gorkom*.²³⁴

Although they do not discuss *Van Gorkom*, Blair and Stout do cite several cases that purportedly endorse, over the objection of shareholder plaintiffs, director action that subordinates the interests of shareholders to those of other constituents.²³⁵ More precisely, Blair and Stout point out that courts allow directors to make charitable donations, protect local communities, forgo projects that would harm creditors, and ward off takeovers that appear to be in the interest of shareholders.²³⁶ Each of these decisions, Blair and Stout say, "explicitly authorizes directors to sacrifice shareholders' interests to protect other constituencies."²³⁷

It is certainly true that some Delaware decisions affirm director action that is favorable to nonshareholder constituencies. Nonetheless, many actions that benefit nonshareholders in the short run may well produce long term benefits for shareholders.²³⁸ As shown below, each of the decisions that Blair and Stout invoke is consistent with the shareholder primacy norm, and some unambiguously support it.

233. See David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 255; Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 607-10 (1992); Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 125-26 (1992).

234. It also should be noted that the conception of directors' fiduciary duties embraced in *Van Gorkom* is applicable in the context of derivative actions as well. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1985) (holding that, once a firm is "in play," directors must "obtain[] the highest price for the benefit of the stockholders") (emphasis added); *Gimbel v. Signal Cos.*, 316 A.2d 599 (Del. Ch. 1974) (enjoining proposed sale based on showing that sale price was too low, thus suggesting that directors had breached their duty of care by negotiating an inadequate price).

Moreover, Delaware courts have characterized as "derivative" actions those that challenge efforts by directors to entrench themselves by warding off takeover proposals, thus depressing the value of a firm's shares. *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1069-73 (Del. Ch. 1985), *aff'd* 500 A.2d 1346 (Del. 1985); see also *infra* notes 276-80 and accompanying text (describing so-called "duty to auction" under Delaware law).

235. Blair & Stout, *supra* note 9, at 301-03.

236. *Id.*

237. *Id.* at 303 (emphasis omitted).

238. Cf. *Revlon*, 506 A.2d at 182 (holding that directors may consider interests of other constituencies only when doing so will plausibly advance the welfare of shareholders); see also *supra* notes 134-37 and accompanying text.

Consider first the authority of directors to cause the corporation to make charitable donations. To be sure, courts have given directors substantial discretion to devote a corporation's resources to charitable causes.²³⁹ Moreover, all states have enacted statutes authorizing corporate donations for charitable, scientific, and educational purposes.²⁴⁰ Yet, the breadth and nature of this discretion is actually inconsistent with the mediating hierarch model that Blair and Stout propose. That model, after all, contemplates that directors will put aside shareholder interests when doing so is necessary to protect or reward those constituencies *that have made team-specific investments*.²⁴¹ Yet, neither case law nor statutes require directors to confine charitable contributions to those entities that have made investments specific to the corporation.²⁴²

Of course, some charities or other nonprofit organizations may make investments that are specific to a public corporation. A hospital, for instance, may build a cancer treatment facility on the expectation that a pharmaceutical company will provide free or below-cost experimental drugs for the facility's patients. There is no reason to believe, however, that most or even a significant proportion of the charities that firms patronize have, in fact, made such investments. The Corporation for Public Broadcasting has made no investments specific to any public corporation; yet, many public corporations routinely contribute large sums to the entity. Indeed, some scholars assert that corporate charitable contributions too often reflect the personal predilections of managers or their spouses and bear little or no relation to the corporation's interests.²⁴³

If Blair and Stout's account of corporate charitable giving were correct, one would expect corporations to target their largesse on

239. Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579, 605-09 (1997).

240. *Id.* at 602-05 (collecting and analyzing statutes).

241. *See supra* notes 134-37 and accompanying text.

242. *See Kahn, supra* note 239, at 603 (concluding that state statutes all "authorize seemingly unlimited philanthropic contributions from corporate capital without regard to whether the firm will be benefited thereby").

243. Jayne W. Barnard, *Corporate Philanthropy, Executives' Pet Charities and the Agency Problem*, 41 N.Y.L. SCH. L. REV. 1147 (1997); Kahn, *supra* note 239, at 609-20.

entities that have, in fact, made firm-specific investments. One would also expect reported cases finding breaches of the duty of care where directors had strayed from this limitation.²⁴⁴ Nevertheless, Blair and Stout provide no evidence that corporations generally support charities that have made investments specific to them; nor do they cite any case law that justifies corporate giving on this ground.²⁴⁵

Moreover, Blair and Stout do not consider whether alternative explanations better account for the vast authority over charitable donations that corporate law vests in directors. For instance, some courts and scholars have suggested that, because corporations receive significant benefits from the public, they have a correlative duty to "give something back" to the community.²⁴⁶ This view justifies corporate giving, regardless of whether such contributions are profitable for the firm, and regardless of whether the recipients have made firm-specific investments. Others have suggested that corporate charitable contributions can and usually do serve the financial interests of the firm by building political support, generating favorable publicity, or even developing markets for a firm's products.²⁴⁷ Indeed, donations to local charities can function

244. Of course, such suits would fare poorly under current law, given the business judgment rule. But this simply begs the question of why Delaware courts would apply the business judgment rule in such cases. If, as Blair and Stout claim, directors are constrained "primarily by their fiduciary duties," one would expect courts to scrutinize such decisions more carefully, to ensure that recipients of such gifts are, in fact, members of "the team." Blair & Stout, *supra* note 9, at 291.

245. The one decision that Blair and Stout do cite, *Theodora Holding Corp. v. Henderson*, 257 A.2d 398 (Del. Ch. 1969), actually contradicts the mediating hierarch justification for corporate giving. There the Court of Chancery approved as "reasonable" a corporate gift to a foundation run by the firm's controlling shareholder. *Id.* at 405. The gift was made "to provide a fund for the financing of a western camp for under privileged boys . . . where [the controlling shareholder] maintain[ed] an underground home." *Id.* at 402. There is no indication that the summer camp, which was apparently opened by the foundation, had made any investments that were specific to the corporation. At any rate, the Court of Chancery approved the gift for "deprived but deserving young people" as "reasonable" because "a large segment of youth is alienated even from parents who are not entirely satisfied with our present social and economic system." *Id.* at 405. Such a gift, the court said, would "provid[e] justification for large private holdings, thereby benefiting [shareholders] in the long run." *Id.*

246. *E.g.*, *A.P. Smith Mfg. Co. v. Barlow*, 98 A.2d 581, 585-87 (N.J. 1953).

247. *E.g.*, Joseph Galaskiewicz, *Corporate Contributions To Charity: Nothing More Than A Marketing Strategy?*, in *PHILANTHROPIC GIVING: STUDIES IN VARIETIES AND GOALS* 246 (Richard Magat ed., 1989) (listing several profit-related goals of corporate charity, including stimulation of marketing, public relations, generation of long-term loyalty of workers and

as a hostage, creating goodwill that would be forfeited if the firm were to depart from the community.²⁴⁸ This second explanation suggests that charitable giving is just another business decision, over which directors should have broad discretion.²⁴⁹ Such discretion, of course, is perfectly consistent with the principal-agent model, particularly in light of the market mechanisms that can discipline directors who cause the firm to make questionable donations.²⁵⁰ Both explanations, of course, do a better job accounting for the state of the law regarding charitable giving than an explanation that treats directors as mediating hierarchs.

Blair and Stout also assert that courts have empowered directors to consider the effects of a firm's activities on surrounding communities, even when doing so is detrimental to shareholders.²⁵¹ Blair and Stout cite one case for this sweeping proposition: *Shlensky v. Wrigley*.²⁵² *Shlensky*, however, said no such thing, and actually militates *against* the mediating hierarch view. There a disgruntled shareholder challenged the decision by the corporation that owned the Chicago Cubs not to install lights at Wrigley Field.²⁵³ The plaintiff alleged that the Cubs' president and eighty-percent shareholder, Philip Wrigley, made the decision for reasons unrelated to shareholder welfare. More precisely, the plaintiff alleged that Wrigley believed that baseball was a daytime sport and

consumers, and generation of tax benefits).

248. Cf. *supra* notes 246-48 and accompanying text (firms can create credible commitments to remain in a community by making investments specific to the region).

249. See *Paramount Communications, Inc. v. Time, Inc.* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, ¶ 93,277 & n.15 (Del. Ch. 1989), *aff'd*, 571 A.2d 1140 (Del. 1989) (stating that corporate law allows directors to "follow a course designed to achieve long-term value even at the cost of immediate value maximization" and thus allows directors "to make reasonable charitable contributions, to grant scholarships or take other action that will have a direct or immediate positive impact upon the financial performance of the firm").

250. See 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, 1208-10 (1999) (describing how market constraints ensure that corporate philanthropy advances shareholder welfare); see *supra* notes 246-48 and accompanying text.

251. Blair & Stout, *supra* note 9, at 303.

252. *Id.* at 303 n.141 (citing *Schlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968)).

253. *Shlensky*, 237 N.E.2d at 777-78 (describing these allegations).

that the installation of lights and night baseball would cause the surrounding neighborhood to deteriorate.²⁵⁴

Shlensky, of course, involved a closely held corporation and thus would seem to be beside the point for scholars offering a theory that applies solely to public firms.²⁵⁵ At any rate, while the Illinois Supreme Court affirmed the trial court's dismissal of the suit, it did not hold that Philip Wrigley could consider local communities to the detriment of shareholders, or, for that matter, use the firm's assets to advance his personal beliefs. To the contrary, the court found it necessary to hypothesize some shareholder-regarding rationale for Wrigley's decision.²⁵⁶ The court surmised that any deterioration of the surrounding community might deter families from attending ball games, thus justifying a refusal to install lights.²⁵⁷ Moreover, the court suggested that, were the neighborhood to deteriorate, the corporation itself would suffer a reduction in the value of the property where the stadium was located.²⁵⁸ It did not matter, the court said, that other major league teams had installed lights and were playing night baseball; directors were required to make an independent *business* judgment, and could not simply mimic the decisions of others.²⁵⁹ The reasoning of *Shlensky*, then, is fully consistent with the principal-agent conception of the firm, but inconsistent with the mediating hierarch view.

Finally, Blair and Stout see significant support for their position in Delaware case law regarding the proper role of directors in responding to uninvited takeover bids. More precisely, Blair and

254. *Id.* at 778.

255. See Blair & Stout, *supra* note 9, at 281 n.74 (defining as "private" a corporation that is "nominally held by the public but effectively controlled by a single shareholder or group of shareholders"). Elsewhere in their article, Blair and Stout argue that case law involving closely held firms is not a useful guide for understanding the duties of directors in publicly held firms. See *id.* at 301-02.

256. *Shlensky*, 237 N.E.2d at 780 ("Plaintiff in the instant case argues that the directors are acting for reasons unrelated to the financial interest and welfare of the Cubs. However, we are not satisfied that the motives assigned to Philip K. Wrigley, and through him to the other directors, are contrary to the best interests of the corporation and the stockholders.") (emphases added).

257. *Id.*

258. *Id.*

259. *Id.* at 781 ("Directors are elected for their business capabilities and judgment and the courts cannot require them to forego their judgment because of the decisions of directors of other companies.").

Stout note that Delaware courts allow directors to fend off takeovers even when bidders offer a substantial premium over and above the firm's current market value.²⁶⁰ Because "modern financial theory" holds that the price of a security reflects the best estimate of its true value, they reason, courts that allow defensive tactics in these situations must be rejecting the shareholder primacy norm in favor of a mediating hierarch approach.²⁶¹

This argument falls short. Certainly modern financial theory, more precisely, the efficient capital markets hypothesis, holds that the price of a common share reflects the best estimate of the net present value of the pro rata earnings attributable to it.²⁶² Moreover, principal-agent theorists have generally embraced the efficient capital markets hypothesis.²⁶³ Still, rejection of this hypothesis does not entail rejection of the shareholder primacy norm or embrace of a mediating hierarch approach. Indeed, the Delaware Supreme Court rejected the efficient capital markets hypothesis in, of all cases, *Smith v. Van Gorkom*. There, the directors invoked the hypothesis, arguing that they did not have to perform a study of Trans Union's intrinsic value before recommending a sale of the company but could instead rely upon the price set by the stock market.²⁶⁴ The court squarely rejected this argument, holding that it was based upon what the court called "a clearly faulty, indeed fallacious, premise," i.e., that a firm's share price reflected its "true worth."²⁶⁵

While many principal-agent theorists have criticized *Van Gorkom* for its rejection of the efficient capital markets hypothesis, the decision quite plainly rests upon a shareholder primacy norm.²⁶⁶ Similarly, Delaware decisions approving defensive measures in the face of substantial premia rest upon a desire to protect and enhance

260. Blair & Stout, *supra* note 9, at 304-05.

261. *Id.*

262. DOOLEY, *supra* note 28, at 473-82 (describing various versions of the efficient capital markets hypothesis); *id.* at 245 (stating that efficient capital markets hypothesis is "perhaps the best established economic postulate of our time").

263. *E.g.*, Butler & Ribstein, *supra* note 173, at 34-35.

264. *Smith v. Van Gorkom*, 488 A.2d 858, 875 (Del. 1985) (recounting director's argument).

265. *Id.* at 876.

266. See *supra* note 234 and accompanying text (explaining that *Van Gorkom* rested upon shareholder primacy norm); see also Fischel, *supra* note 231, at 1448-49 (criticizing *Van Gorkom* court for ignoring the efficient capital markets hypothesis).

shareholder value.²⁶⁷ More precisely, Delaware courts have recognized two legitimate bases for defensive tactics: protecting shareholders from coercive, "underpriced" offers, and ensuring that shareholders do not "mistakenly" accept offers that understate the firm's "intrinsic value."²⁶⁸ To be sure, many principal-agent theorists have called for more intrusive judicial scrutiny of defensive tactics.²⁶⁹ On the other hand, some scholars equally committed to the norm of shareholder primacy have endorsed something like the Delaware approach as the best method of maximizing shareholder wealth.²⁷⁰ Such an approach, which recognizes only shareholder-regarding justifications for defensive tactics, is inconsistent with the mediating hierarch model.²⁷¹

267. See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1150 n.12 (Del. 1989) ("[W]e endorse the Chancellor's conclusion that it is not a breach of faith for directors to determine that the present stock market price of shares is not representative of true value or that there may indeed be several market values for any corporation's stock. We have so held in another context."). The Chancery Court was even more explicit, rejecting the efficient capital markets hypothesis, while at the same time holding that directors could adopt defensive measures to enhance the welfare of *shareholders*.

This view [the efficient capital markets hypothesis] may be correct. . . . Perhaps wise social policy and sound business decisions ought to be premised upon the assumptions that underlie that view. But just as the Constitution does not enshrine Mr. Herbert Spencer's social statics, neither does the common law of directors' duties elerate the theory of a single, efficient capital market to the dignity of a sacred text.

Directors may operate on the theory that the stock market valuation is "wrong" in some sense, without breaching faith with shareholders. No one, after all, has access to more information concerning the corporation's present and future condition. . . . The record in this case refers to instances in which directors did function on a theory that they understood better than the public market for the firm's shares what the value of their firm was, and were shown by events to be correct.

Paramount Communications, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, 93,277.

268. Ronald J. Gilson & Reiner Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 267 & n.65 (1989) (summarizing Delaware law).

269. E.g., EASTERBROOK & FISCHER, *supra* note 4, at 171-74.

270. Gilson & Kraakman, *supra* note 268, at 271-73 (arguing in favor of a proportionality test under which management must justify defensive measures by showing the existence of a threat to shareholder interests); *id.* at 267 n.65 (asserting that a departure from the shareholder primacy norm where defensive tactics are concerned "would render most of corporate law incoherent"); Macey, *supra* note 71, at 200-04 (arguing that in many instances defensive tactics can enhance investor welfare).

271. Blair and Stout cite the Court of Chancery decision in *Paramount Communications*,

Additional Delaware case law makes it even plainer that directors must maximize shareholder value when responding to tender offers. In particular, the Delaware Supreme Court has held that, once it becomes clear that a firm will be sold to some bidder, directors must do what they can to make sure that the highest bidder prevails, regardless whether they might agree with the highest bidder's future business strategy.²⁷² Like the duties implied in *Van Gorkom*, these duties are directly contrary to a mediating hierarch approach.²⁷³ Bidders who offer a premium over other potential purchasers may do so because they plan greater restructuring of the target's operations—restructuring that may appear opportunistic to other constituents.²⁷⁴ Nevertheless, the Delaware Supreme Court has expressly held that directors may not consider the interests of nonshareholder constituencies in this context unless necessary to further the interests of shareholders.²⁷⁵

Inc., for the proposition that Delaware courts will sustain "a board's discretion to reject a takeover bid at a substantial premium in order to protect the interests of the firm's employees or the community." Blair & Stout, *supra* note 9, at 304. To be sure, Time's Board rejected Paramount's bid in part to "maintain[] a Time culture" of journalistic integrity. *Paramount Communications, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,268. However, the court did not hold that preservation of the firm's culture could justify defensive tactics. Instead, the court sustained the tactics because they were designed, in good faith, "to achieve long-term value [for shareholders] even at the cost of immediate value maximization." *Id.* ¶ 93,277. To be precise, Time's directors argued that thwarting Paramount's \$200 per share bid would allow the firm to pursue a long-term strategy that would raise the price of the firm's shares to between \$208 and \$402. *Id.* ¶ 93,273; *see also id.* ¶ 93,284 (characterizing directors' task as determining "whether it is the better course [of action] from the shareholders' point of view collectively to cash out their stake in the company now") (emphasis added).

The Delaware Supreme Court affirmed the Chancellor's decision, holding that the Directors properly rejected Paramount's offer because, *inter alia*, Time's shareholders were insufficiently informed about the benefits of the competing offers. *Paramount Communications, Inc.*, 571 A.2d at 1153. The Court in no way relied on Time's concern for its culture of journalistic integrity. *See also supra* note 267 and accompanying text (summarizing *Paramount's* conclusion that directors can take defensive steps deemed necessary to enhance long-term shareholder value).

272. *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994); *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1284-85 (Del. 1988); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

273. *See supra* notes 266-72 and accompanying text.

274. *See Mitchell, supra* note 233, at 607-10; Orts, *supra* note 233, at 124-25.

275. *Revlon, Inc.*, 506 A.2d at 182 (voiding tactics purportedly designed to protect creditors because "[a] board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders");

Nevertheless, Blair and Stout assert that Delaware's "duty to auction" actually supports the mediating hierarch model. As they point out, Delaware has limited the directors' duty to auction to those cases in which a single entity or identifiable group threatens to acquire a controlling block of the target firm's voting shares.²⁷⁶ Thus, they argue, the duty to auction only applies when a publicly held corporation is about to become private.²⁷⁷ Coupled with this limitation, they say, the duty to auction simply reflects the law's recognition that public firms governed by a mediating hierarch model may elect to adopt a different model by "go[ing] private."²⁷⁸ Absent such a decision to "go [] private," they say, boards may consider the interests of various constituents when responding to a takeover bid.²⁷⁹

This attempt to explain away Delaware's duty to auction does not withstand scrutiny. Firms need not "go private" to opt out of a mediating hierarch model of governance. Indeed, as shown below, the majority of public corporations have apparently rejected a

see also *Mills Acquisition Co.*, 559 A.2d at 1285 ("The sole responsibility of the directors in such a sale is for the shareholders' benefit."); *id.* at 1286-87 ("Directors are not required by Delaware law to conduct an auction according to some standard formula, only that they observe the significant requirement of fairness for the purpose of enhancing shareholder interests. ... [T]he board's primary objective, and essential purpose, must remain the enhancement of the bidding process for the benefit of the stockholders.").

276. Blair & Stout, *supra* note 9, at 309; see also *Paramount Communications*, 571 A.2d at 1150-51 (holding that *Revlon* duties do not attach where directors propose a merger that leaves the firm's stock dispersed among the public).

277. Blair & Stout, *supra* note 9, at 309.

278. *Id.*

279. *Id.* at 308-09. Blair and Stout cite *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), for the proposition that, in responding to hostile bids, directors may take account of "the impact on ... creditors, customers, employees and perhaps even the community generally." Blair & Stout, *supra* note 9, at 308 (quoting *Unocal*, 493 A.2d at 955). The quoted language, however, was dicta: The directors of *Unocal* did not argue that their defensive tactics were designed to further the interests of nonshareholder constituencies. Moreover, the court sustained the defensive tactics because they protected *shareholders* from an inadequate and coercive offer. *Unocal*, 493 A.2d at 956-58; see also *Mills Acquisition Co.*, 559 A.2d at 1287 n.38 (describing *Unocal* as a decision in which "this Court has upheld actions of directors when a board is confronted with a coercive 'two-tiered' bust-up tender offer") (emphasis added). Subsequent Delaware case law holds that the duties of directors articulated in *Unocal* are no different from those articulated in *Revlon*. *Mills Acquisition Co.*, 559 A.2d at 1287 (stating that, when a shift in control is imminent, "the enhanced duties of the directors in responding to a potential shift in control, recognized in *Unocal*, remain unchanged," and noting that, "[t]his principle pervades *Revlon*").

mediating hierarch approach by vesting de facto control in full-time, inside directors.²⁸⁰ At any rate, the duty to auction cannot be squared with the mediating hierarch model. Yes, a firm *becomes* private once a single entity purchases a controlling block of its shares. Before such a purchase, and during any auction, the firm remains public and, under Blair and Stout's approach, properly subject to a mediating hierarch model of governance. Indeed, the rationale for a mediating hierarch model would seem to be *strongest* at this point, when the firm is in the final period. It is at this very moment, when directors are choosing whether to take the firm private, that employees and creditors are most vulnerable to opportunism, as shareholders seek to maximize the proceeds of any auction by selling to the highest bidder.²⁸¹ The highest bidder, of course, may be the firm or individual who will do the most violence to the settled expectations of employees, creditors, or the community.

Embrace of a mediating hierarch model of governance would require courts to reject a duty to auction, even when a firm was taking itself private. Indeed, allowing public firms to opt out of the mediating hierarch model simply by selling a controlling block to the highest bidder would deprive directors of the ability to make a credible commitment against opportunism, thus undermining the effectiveness of such a model.²⁸² Nevertheless, courts have held that directors must take whatever steps are necessary to obtain the highest possible bid for shareholders when it is clear that some bidder will obtain a controlling block.²⁸³ This rejection of a mediating hierarch approach when it is most needed casts serious doubt on Blair and Stout's characterization of Delaware corporate law.

280. See *infra* notes 286-91 and accompanying text.

281. McDaniel, *supra* note 90, at 434-35 ("[I]n a takeover contest managers may become more willing to sacrifice existing bondholders in order to maximize stockholder gains. . . . The manager of a target corporation may decide he is in the final period and act accordingly."); see also *supra* notes 9-13 and accompanying text (discussing the risk that managers and shareholders will exploit other constituencies of the corporation).

282. See *supra* notes 15-18 and accompanying text (showing that Blair and Stout's mediating hierarch model is designed to empower firms to make a credible commitment against opportunism).

283. *Mills Acquisition Co.*, 559 A.2d at 1285-87.

In the end, the various doctrines that Blair and Stout invoke are entirely consistent with a principal-agent conception of corporate governance. Moreover, some of these doctrines are inconsistent with a mediating hierarch approach. Contrary to Blair and Stout's assertion, then, Delaware law reflects a principal-agent approach. Adoption of a mediating hierarch model, on the other hand, would require significant changes in Delaware's corporate law.

C. Rejection of the Mediating Hierarch Model in Practice

Blair and Stout have failed to address powerful evidence that contradicts their thesis, namely the failure of states or public corporations to constitute directors as the sort of mediating hierarchs they envision. For decades, numerous corporate law scholars have urged states to mandate that the boards of public corporations consist solely of truly independent directors.²⁸⁴ States have simply rejected these proposals, however. While corporate law *allows* shareholders to elect boards that are truly independent of themselves, management, and employees, there is no requirement that they do so in practice. To be sure, a majority of the directors of large publicly held corporations are not employed by the firm and hence can be deemed "outside directors."²⁸⁵ Despite this nominal independence, however, scholars generally agree that boards of directors are beholden to management. The Chairman of the Board, for instance, is almost always the current CEO or another officer of the company.²⁸⁶ Moreover, by virtue of his or her dominant position within the firm, and position as Chairman of the Board, the CEO can influence, if not control outright, the selection of inside and outside directors.²⁸⁷ Further, the CEO and other prominent officers

284. DOOLEY, *supra* note 28, at 200-02 (describing reform proposals).

285. JAY W. LORSCH & ELIZABETH MACIVER, *PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS* 17-18 (1989).

286. See James A. Brickley et al., *Corporate Leadership Structure: On the Separation of the Positions of CEO and Chairperson of the Board* (Aug. 23, 1995) (unpublished manuscript, on file with the author). Professor Brickley and his coauthors surveyed 737 large firms and reported that over 80% of these companies united the office of Chairman of the Board and CEO in the same person. Moreover, another 17% of the sample selected as chairmen individuals who were either former CEOs or occupants of other high offices. Only 2.57% of the sample had chairmen who were not current or former employees of the company.

287. ROBERT A.G. MONKS & NELL MINOW, *WATCHING THE WATCHERS: CORPORATE*

are able to control the direction of the board. The CEO can literally "set the agenda"—deciding what general issues the full board will address.²⁸⁸ He or she can also influence the board informally, by presenting options in a way that frames issues in a manner of managers' choosing.²⁸⁹

Thus, while the public corporation is often subject to the nominal control of outside directors who could, theoretically, act as mediating hierarchs, actual control of such firms resides in inside directors, particularly the CEO. States or corporations could confer more actual authority on outside directors, empowering them to act as true mediating hierarchs.²⁹⁰ They have not, thus undermining Blair and Stout's assertion that a mediating hierarch model of governance is superior to the shareholder primacy norm.²⁹¹

GOVERNANCE FOR THE 21ST CENTURY 182-84, 195-96 (1996) (opining that "the CEO plays an important, even dominant role in the selection of director candidates").

288. CLARK, *supra* note 27, at 108 (stating that officers initiate and shape corporate decisions and the directors simply approve them); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 914 (1996) ("[S]ince most CEOs also serve as the chairman of the board, the CEOs often control both the agenda of the board meetings and the amount of information given to the board supporting the agenda.").

289. Lin, *supra* note 288, at 914 ("Rather than presenting all of the possibilities to the board, management may present only the project it prefers. Under these circumstances, outside directors may end up approving [the wrong] project . . . because they are unaware of the other possibilities.").

290. For instance, firms could provide in their bylaws that the Chairperson of the Board would be an outside director.

291. Corporate law does sometimes encourage firms to employ outside directors to review or approve certain transactions. For instance, although courts will defer to decisions by outside directors setting management compensation, similar determinations by inside directors will be subject to more exacting scrutiny. Lin, *supra* note 288, at 905 & nn.35-36 (discussing Delaware authorities); see also DEL. CODE ANN. tit. 8, § 144 (1991 & Supp. 2000) (removing common law bar to interested director transactions if such decisions are approved by outside directors). But see *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976) (conducting fairness review despite approval by shareholders pursuant to title 8, section 144 of the Delaware Code). Because firms cannot opt out of these rules by contract, their existence does not reflect firms' judgment that outside director review of such transactions is cost-effective. At any rate, it would appear that such rules are crafted to protect *shareholders* from opportunism by managers, thus undermining the assertion by Blair and Stout that the structure of fiduciary duties is limited to regulation of conduct that injures several constituencies. See *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (stating that defensive tactics blessed by outside directors receive extra deference); see also *supra* notes 214-15 and accompanying text (describing assertion by Blair and Stout that, based on a director's fiduciary duties, courts only penalize conduct of the director that injures several constituencies).

CONCLUSION

The "principal-agent" model, which implies a shareholder primacy norm, is the dominant paradigm of corporate law. Blair and Stout have offered a competing paradigm, in which directors of public corporations act as "mediators" between various constituencies that make investments specific to the corporate team. According to these scholars, this mediating hierarch model of corporate governance is superior to a principal-agent conception, as it empowers directors to make credible commitments to refrain from opportunism and thus enhances the public corporation's ability to attract team-specific investment. Blair and Stout claim to find support for their thesis in Delaware corporate law which, they say, is inconsistent with a principal-agent model but entirely consistent with a mediating hierarch conception.

This Essay has offered a rebuttal to Blair and Stout's thesis. As an initial matter, it does not appear that departure from the single-owner standard that characterizes private firms will in fact reduce the risk of opportunism where public corporations are concerned. There is no reason to believe that nonshareholder participants in public corporations face a greater risk of opportunism than their counterparts in private firms. If anything, certain inherent attributes of publicly held corporations ultimately render such constituents *less* vulnerable to opportunism than similar participants in private firms. At the same time, it seems clear that shareholders of public corporations are *more* vulnerable to opportunism than those who supply equity capital to private firms, and thus are more in need of the sort of protection provided by the shareholder primacy norm. As a result, there is no apparent reason why the law of public corporations should depart from the single-owner approach that characterizes private firms.

At any rate, even if a mediating hierarch model could reduce the prospect of opportunism and enhance a firm's ability to attract team-specific investment, such an approach to firm governance would entail significant ownership costs, costs that would likely outweigh any purported benefits of such a model. By vesting ultimate control over the public corporation in disinterested arbiters, the mediating hierarch model would deprive society of

many of the benefits ordinarily associated with the corporate form. Precisely because they are disinterested, hierarchs would lack the sort of hands-on expertise that normally characterizes many corporate directors. More importantly, mediating hierarchs would have no claim to the team's residual product, and they would not be accountable to anyone who did. Thus, they would have little incentive to maximize anything other than their own welfare and therefore would not be effective monitors of the team under their supervision.

Delaware corporate law does not support Blair and Stout's thesis. To be sure, the law of Delaware grants directors broad discretion of the sort consistent with a mediating hierarch model of governance. However, this grant of discretion is equally consistent with a principal-agent model, particularly when one considers the various market mechanisms that encourage directors to pursue shareholder interests. Indeed, certain aspects of Delaware law—most notably the "duty to auction"—are flatly inconsistent with a mediating hierarch model, and only consistent with a principal-agent account. Delaware, at least, has apparently decided that the principal-agent model, and with it the shareholder primacy norm, is superior to alternative models of corporate governance.