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ESSAY

NEW GAME PLAN OR BUSINESS AS USUAL? A CRITIQUE OF THE TEAM PRODUCTION MODEL OF CORPORATE LAW

David Millon[*]

IN an important article published last year in the *Virginia Law Review*, Margaret Blair and Lynn Stout present a new economic theory of the corporation and of corporate law.[1] This is the team production model ("TPM"). Their analysis is important because it effectively challenges the currently dominant analytical approach to corporate law, which is the principal-agent model of the relationship between the corporation's shareholders and its management.[2] According to the principal-agent model, management's duty is to maximize the wealth of the shareholders, who are the owners of the corporation. The task of corporate law is to promote that goal. This understanding of corporate law has come to be known as the "shareholder primacy" model.[3] It stands in stark

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* Associate Dean for Academic Affairs and Professor of Law, Washington and Lee University School of Law. The author gratefully acknowledges the insightful comments and suggestions of Bill Bratton, Lyman Johnson, and Marleen O'Connor, as well as financial support from the Frances Lewis Law Center, Washington and Lee University School of Law. A preliminary version of some of the ideas included in this Essay was presented at a panel on "Socio-Economic Perspectives on Corporate Law and Responsibility" held at the American Association of Law Schools' Annual Meeting in January 2000.

[1] Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247 (1999). This article is reprinted, together with commentary by a number of authors, in Symposium, Team Production in Business Organizations, 24 J. Corp. L. 743 (1999). Subsequent references are to the original *Virginia Law Review* version.

[2] See Blair & Stout, supra note 1, at 248 n.1 (citing representative examples of the principal-agent approach from economic and legal literature).

[3] The term "shareholder primacy" was coined to express the idea of shareholder preeminence in relation to the corporation's various other constituencies. See Lyman Johnson & David Millon, Missing the Point About State Takeover Statutes, 87 Mich. L. Rev. 846, 848 (1989). In addition to providing substantive content to the definition of the board's duty (and, by implication at least, to the issue of corporate purpose), the shareholder primacy idea also has implications for the question of control. The

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contrast to competing normative theories that reject shareholder primacy in favor of the idea that management owes duties to all the corporation's various stakeholders[4] or of broader notions of corporate social responsibility.[5] These rival theories, though they have found favor with state legislators[6] and a few judges,[7] have made

hostile takeover explosion of the 1980s revealed a latent ambiguity on this issue. On the one hand, it is possible to interpret shareholder primacy in terms of the shareholders' right to decide for themselves what is in their best interest, as, for example, when they are faced with a hostile tender offer opportunity. On the other hand, corporate law can still claim to be committed to shareholder primacy while vesting in the board of directors the power to decide whether a particular bid is in the shareholders' interest. See Lyman Johnson & David Millon, Misreading the Williams Act, 87 Mich. L. Rev. 1862, 1882–86 (1989) (contrasting "shareholder autonomy" and "shareholder protection" versions of shareholder primacy).

[4] According to one formulation, the term "stakeholder" embraces "[t]he constituencies that are affected—favorably or adversely—by the operation of the corporation." These include shareholders and nonshareholder constituencies who have contractual relationships with the corporation and perhaps also others who, though not linked by contract, nevertheless stand to gain or lose as a result of a corporation's activities. See Clarkson Centre for Business Ethics, Principles of Stakeholder Management 2 (1999).

[5] The corporate social responsibility idea emphasizes the enormous size and power of the American business corporation and argues that that power should be exercised with due regard to the wide range of harmful effects relentless commitment to profit maximization can entail. See, e.g., Ralph Nader et al., Taming the Giant Corporation (1976); see also E. Merrick Dodd, Jr., For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145 (1932) (arguing that corporations are beginning to view their role as one demanding greater social responsibility). Some commentators have suggested that current interest in stakeholder theory is nothing but a rehash of older debates about corporate social responsibility. See, e.g., Stephen M. Bainbridge, Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship, 82 Cornell L. Rev. 856, 902–03 (1997) (reviewing Progressive Corporate Law (Lawrence E. Mitchell ed., 1995)). This is too simplistic. Stakeholder theory aims to define management's duty as running to all those who have a stake in the corporation's productive activity. Most obviously, these constituencies include shareholders, employees, creditors, and consumers. Theories of corporate social responsibility cast a potentially broader net, emphasizing all of the social costs of corporate activity, and therefore embrace, for example, environmental or political concerns as well as stakeholder interests. Stakeholder theory can blend into social responsibility theory if one defines "stakeholder" to include anyone affected by a corporation's activities, but this comes at the expense of considerable dilution of the stakeholder concept. For discussion of these issues, see David Millon, Personifying the Corporate Body, Graven Images, 1995, at 116, 126–27.

[6] Approximately 30 states have enacted statutes that authorize directors to consider nonshareholder as well as shareholder interests in making decisions for the corporation. Only one of these statutes (Connecticut's) is mandatory. For discussion, see David Millon, Redefining Corporate Law, 24 Ind. L. Rev. 223 (1991) [hereinafter Millon, Redefining Corporate Law]; Lawrence E. Mitchell, A Theoretical and Practical

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only limited headway in the legal academy, where shareholder primacy and its narrow vision of corporate management's obligations continue to predominate.

Blair and Stout now introduce a sophisticated economic argument for rejection of shareholder primacy and—at least by implication—for a more spacious understanding of the board's role. Conceiving of the various participants in the corporation as a team, TPM describes the directors as independent "mediating hierarchs whose job is to balance team members' competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together."[8] Because Blair and Stout confront the dominant paradigm on its own law-and-economics turf, their work promises to succeed where other noneconomic arguments have failed to make significant headway.

After a brief synopsis and appreciation of Blair and Stout's analysis, this Essay will consider in Part I two of TPM's central features. Part II will question Blair and Stout's claim that corporate law *already* reflects TPM's rejection of shareholder primacy. Although Blair and Stout offer some useful insights on this question, I will suggest that they ultimately fail to refute the widely held view that corporate law currently endorses a principal-agent, shareholder primacy understanding of the board's responsibility. There may in fact be enough "play in the joints" to accommodate a board that seeks to act as mediator among all members of the corporate team, but corporate law as currently constituted does not mandate

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Framework for Enforcing Corporate Constituency Statutes, 70 Tex. L. Rev. 579 (1992) [hereinafter Mitchell, Theoretical and Practical Framework].

[7] Most notably, the Delaware judiciary has displayed some ambivalence toward shareholder primacy claims in the hostile takeover context, apparently due to concern for nonshareholder interests. See, e.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (authorizing board to consider in evaluating a takeover bid, among other factors, "the impact on 'constituencies' other than shareholders"); Paramount Communications v. Time, Inc., 1989 Fed. Sec. L. Rep. (CCH) ¶ 94,514 at 93,267 (Del. Ch. 1989) (discussing the preservation of "Time culture" and the political value of journalistic independence as rationales for blocking a hostile tender offer), aff'd, 571 A.2d 1140 (Del. 1990). For a discussion of the Delaware judiciary's vacillating commitment to shareholder primacy, see Lyman Johnson, The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law, 68 Tex. L. Rev. 865 (1990); David Millon, Theories of the Corporation, 1990 Duke L.J. 201 [hereinafter Millon, Theories of the Corporation].

[8] Blair & Stout, supra note 1, at 280–81.

that vision and is equally capable of accepting director commitment to shareholder wealth maximization.

My doubts about TPM's descriptive utility are not, however, this Essay's principal focus. Even if Blair and Stout's descriptive claims are overstated or inaccurate, TPM could still make a valuable contribution if it were read as a normative theory justifying rejection of the shareholder primacy orthodoxy. Part III therefore will raise more fundamental concerns about TPM's conception of the board of directors as an independent "mediating hierarch." As elaborated by Blair and Stout, TPM contends that extralegal pressures (which the authors term "political") rather than corporate law determine the board's division of corporate revenues (or rents) among shareholders and nonshareholders.[9] (If TPM is better viewed as a normative theory, the claim would be that politics rather than law *should* determine rent allocation.) Because TPM does not contemplate insulation of the board from these extralegal pressures, the fact (if it is a fact) that the board is not legally committed to shareholder primacy is not necessarily of any practical significance; political pressures may influence the board's decisionmaking every bit as much as legal rules. Distributional outcomes need be no different than they would be if dictated by the shareholder primacy principle.

The board's lack of independence from extralegal pressures has potentially important efficiency consequences. First, it encourages team members, including shareholders and employees, to engage in costly rent-seeking activities as they compete with each other to obtain the largest possible share of corporate revenues. Second, political control of the board by shareholders may be inefficient because it leads to allocation decisions that forfeit potential productivity gains (or "X-efficiency"). These efficiency questions will be considered in Part III.B.

Part III.C will then take up an issue of greater importance from a progressive perspective—the distributional implications of TPM's conception of the board's role. Because the board is supposed to make decisions about rent allocation in response to political pressures rather than legal rules, a corporation's shareholders, workers, and other team members earn only those shares of production sur-

[9] Id. at 323.

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plus that are obtainable through the exercise of political power targeted at the board. In this regard, TPM mirrors the shareholder primacy model's standard view of intracorporate relations, the fundamental premise of which is the principle that nonshareholder rights are limited to whatever can be bargained and paid for. Thus TPM does not advance progressive efforts to construct a broader understanding of management's responsibility to nonshareholders aimed at improving distributional outcomes currently available through market interactions. Despite its apparent critical promise, TPM turns out to be an elaborate justification for the status quo.

I. THE TEAM PRODUCTION MODEL OF THE CORPORATION

Drawing on economic literature,[10] Blair and Stout model the public corporation as a complex nexus of inputs provided by a range of team members, including shareholders, managers, lower-level employees, lenders, and local communities.[11] These contributors have banded together because they believe they can earn a better return on their labor or capital through cooperative endeavor than they can individually. However, division of the rents generated by their joint activity presents a practical problem. The output produced by the team typically is nonseparable, meaning that it is impossible to determine the value of each team member's contribution to the overall effort. Some mechanism for rent allocation is therefore necessary.

Ex ante allocation by means of agreement among the team members (for example, fixed wages) is problematic because it invites shirking and free-riding: Any individual participant knows that his or her return is already established, regardless of the amount of effort actually expended. If it is agreed that rents will be distributed on some preset percentage basis, an individual whose low effort reduces total output still gains the full benefit of reduced commitment to the team while spreading the cost among all the

[10] Blair and Stout draw principally on Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 Am. Econ. Rev. 777 (1972); Bengt Holmstrom, Moral Hazard in Teams, 13 Bell J. Econ. 324 (1982); Raghuram G. Rajan & Luigi Zingales, Power in the Theory of the Firm, 113 Q.J. Econ. 387 (1998).

[11] As elaborated by Blair and Stout, TPM applies only to public (as opposed to closely-held) corporations. See Blair & Stout, supra note 1, at 249, 276, 281.

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team members. If enough people respond to either kind of ex ante compensation arrangement by shirking, the team's joint output could be substantially lower than it otherwise might be, leaving everyone worse off.

An agreement to divide production rents ex post may encourage closer to optimal effort if the participants have confidence that the allocation process will result in fair returns. However, this solution is likely to result in wasteful squabbling as team members try to grab for themselves the largest possible shares. This kind of rent-seeking behavior is costly for all involved, so individual team members end up with less than they otherwise might earn from their venture. Like the ex ante approach, the incentives under the ex post scenario generate suboptimal results for the participants.

A third possible solution is also unsatisfactory. Assignment of the right to allocate shares of the jointly produced revenues to one member of the team could obviate the most apparent problems associated with the ex ante and ex post arrangements. If the team member with control over rent allocation has the ability to monitor the other team members, he or she can withhold compensation to those who shirk and reward those who live up to expectations. Vesting the power of allocation in a single team member would also eliminate the occasion for wasteful rent-seeking, at least as long as team members have no reason to attempt to influence allocation decisions. Nevertheless, this solution would generate new problems of its own. If one team member—say the shareholders as a class—enjoys the authority to divide the pie, the possibility that other team members would quit the team could discourage excessive self-dealing. However, the exit threat may not be credible if team members—such as employees—have made firm-specific human capital investments by acquiring specialized knowledge and skills that are not fully transferable to another job. In that case, defection would mean forfeiture of the value of those investments. The possibility of opportunistic self-dealing by the rent-allocator therefore would discourage hnman capital investment as well as high effort by other team members, resulting in lower productivity. Again the outcome is suboptimal.

Responding to the challenges posed by team production, Blair and Stout turn to Rajan and Zingales' idea of giving an independent third party control over the team's assets and the authority to

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monitor job performance and allocate production revenues among the team members.[12] Blair and Stout's important insight is to suggest that the corporate entity and the board of directors can serve this function.[13] By vesting ownership of the rents generated by joint production in the corporation and assigning responsibility for their division to an independent board of directors subject to a legal prohibition on self-dealing, the various team members submit themselves to an independent monitor that will police shirking and provide a disinterested agency for rent allocation.[14] In addition, they create an environment in which each team member can invest financial or human capital—including firm-specific investments—without fear of opportunistic exploitation by other team members. Charged with the responsibility to look after the interests of all team members, the corporation's independent board of directors thus serves as a "mediating hierarch."[15]

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[12] See Rajan & Zingales, supra note 10, at 422.

[13] See Blair & Stout, supra note 1, at 271–76.

[14] See id. at 277–78.

[15] Id. at 274–76. Given the importance that TPM assigns to constraining opportunistic appropriation of firm-specific investments, one puzzle not adequately dealt with by Blair and Stout is the extent to which investments of human and financial capital in public corporations truly are firm-specific. (As elaborated by Blair and Stout, TPM deals only with public corporations.) It may be plausible to think of efforts by workers to develop special skills and the abilities to operate within a particular corporate culture as investments that are firm-specific in the sense of not being readily transferable to new work environments. Shareholders of public companies, however, invest their capital in stock that can be sold at any time, regardless of whether the corporation itself has invested its equity in firm-specific assets. While the value of stock can rise or fall, and mass defection will cause prices to drop, investing cash in the shares of public corporations does not involve a risk of forfeiture that is analogous to—or as severe as—risks faced by investors of firm-specific human capital. (Diversification also allows shareholders to hedge against losses on particular investments, a strategy not available to employees.) In comparison to workers (and other nonshareholders, such as suppliers, customers, or local communities, who may make firm-specific investments), the lower-cost exit option available to shareholders substantially reduces the costs of opportunistic rent-seeking by other team members. If a key player on the team need not fear exploitation by other team members, an important motivation for TPM, one may wonder whether the model actually addresses the reality of public corporations. In contrast, investors of financial capital in closely held corporations typically do make firm-specific investments (since by definition, there is no market for their shares), as do providers of human capital. The problems that TPM addresses thus seem more urgent in that setting. However, Blair and Stout do not apply the model to the closely held firm, and the reason is readily apparent: Participants in these businesses rarely if ever delegate rent allocation authority to an independent third party. To the contrary, a hallmark of closely held firms is the extent to which the

Creating an independent board of directors, however, is only a second-best solution to the team production challenge because the independent board itself has no direct stake in the success of the venture.[16] As an agent acting on behalf of the various members of the team, the board may lack the motivation to perform its monitoring and other management responsibilities as attentively and vigorously as the team members might desire.[17] It also lacks the incentive to pursue optimal rent allocation policies and may therefore be content with payouts to some team members that are minimally sufficient to keep them on board, while allocating any surplus to others.[18] Nevertheless, the mediating hierarch solution appears to be superior to the alternative rent allocation mechanisms discussed above, an advantage that presumably outweighs the agency costs that it entails.[19]

The linchpin of TPM's conception of the board's role is its independence from the corporation's various constituencies. Corporate law's orthodox assumption that the board acts as agent of the shareholders is inappropriate in this context; except for agency costs, the orthodox assumption would be equivalent to the shareholders themselves enjoying rent allocation authority. In that case, a legal prohibition on excessive shareholder compensation would not be sufficient to protect the interests of workers and other nonshareholder claimants because of the difficulties involved in valuing the shareholders' contribution to the team effort. Furthermore, workers lack extralegal leverage with the shareholders because quitting would involve forfeiture of firm-specific human capital investments. TPM's economic rationale for board independence is thus the source of its power as a critique of the traditional shareholder primacy principle.

Blair and Stout are not the first to challenge shareholder primacy, but most other scholars who have done so have not relied primarily on economics.[20] Perhaps for this reason progressive cor-

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various participants typically insist on involvement in management. Mutual trust is probably the principal mechanism for defusing the threat of opportunism.

[16] See id. at 283–84.

[17] See id.

[18] See id. at 325.

[19] See id. at 283–84.

[20] See, e.g., Millon, Redefining Corporate Law, supra note 6; Lawrence E. Mitchell, A Critical Look at Corporate Governance, 45 Vand. L. Rev. 1263 (1992) [hereinafter

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porate law scholarship has had limited impact in the academy, where a law-and-economics approach predominates.[21] Generally, this approach has meant adherence to the assumption that the board's role is to maximize shareholder wealth, leaving nonshareholders to protect their own interests by bargaining for the best return available to them.[22] For critics of shareholder primacy, the great promise of TPM is its effective use of the same conceptual apparatus that has been relied on by its defenders. Here at last is reason to hope that a richer understanding of the board's responsibility to *all* the corporation's stakeholders may actually gain widespread acceptance. Before jumping on the TPM bandwagon, however, progressive critics of shareholder primacy need to look more closely and determine for themselves whether TPM's attractions are as real as they appear to be.

II. TPM AND THE CURRENT STATE OF CORPORATE LAW

Implicit in Blair and Stout's TPM is a powerful normative challenge to the shareholder primacy conception of corporate law. The main thrust of their project, however, is their argument that TPM explains the content of corporate law in its current form. In other

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Mitchell, Critical Look]. But see Marleen A. O'Connor, The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation, 78 Cornell L. Rev. 899 (1993) (using economic analysis to argue for fiduciary duty to employees as well as shareholders). Blair and Stout's TPM bears an interesting resemblance to Lawrence Mitchell's proposal of an independent, self-perpetuating board charged with responsibility for asset distribution among the corporation's various stakeholders. See Mitchell, Critical Look, supra. The result, Mitchell argues, would be a board liberated from shareholder-motivated focus on short-term profitability that is capable of resolving horizontal conflicts among shareholders and nonshareholders in a neutral manner. See id. Marleen O'Connor has proposed a "neutral referee" model of corporate law under which the board would balance the competing interests of workers and shareholders. See O'Connor, supra, at 946–65. Again, the parallel to TPM is apparent.

[21] See William T. Allen, Contracts and Communities in Corporation Law, 50 Wash. & Lee L. Rev. 1395, 1399 (1993).

[22] For examples of defenses of this view presented in economic terms, see Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 36–38 (1991); Stephen M. Bainbridge, In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green, 50 Wash. & Lee L. Rev. 1423, 1443 (1993); Jonathan R. Macey, An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties, 21 Stetson L. Rev. 23, 36–99 (1991); Milton Friedman, The Social Responsibility of Business is to Increase its Profits, N.Y. Times Magazine, Sept. 13, 1970, at 32.

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words, corporate law *already* constitutes the board of directors of the public corporation as the independent mediating agency needed to solve the rent allocation problem presented by team production.[23]

Before proceeding with my principal objective, which is to challenge the utility of TPM as a normative theory, I pause in this Part to evaluate Blair and Stout's descriptive assertion. This extended digression may be of interest because their analysis appears to fly in the face of the orthodox view of corporate law's primary purpose. If Blair and Stout are right, corporate law scholars of all stripes will need to rethink some basic assumptions. Part II.A therefore looks closely at their reading of important elements of legal doctrine and questions the conclusion that TPM explains their content better than a shareholder primacy understanding. Part II.B then considers whether Blair and Stout might more effectively make a different kind of descriptive claim, namely that, notwithstanding legal doctrine's formal endorsement of shareholder primacy, in practice corporate law allows directors the freedom needed to act as independent mediators. According to this view, one might say that corporate law endorses TPM's conception of the board's role not by means of its substantive doctrines, but rather in spite of them, through its inefficacy. After evaluating the validity of that argument, Part II closes with the suggestion that TPM should be thought of as a normative project rather than a descriptive or explanatory one. Part III of this Essay then turns to a critical appraisal of the TPM's normative significance.

A. *Corporate Law's Primary Objective*

It is common coin among commentators to speak of corporate law and its fiduciary doctrines as mandating management regard for shareholder interests over those of other corporate constituencies. For example, Michael Dooley writes, "[I]t is generally agreed that management's principal fiduciary duty is to maximize the re-

[23] See Blair & Stout, supra note 1, at 289 ("By preserving directors' independence and imposing on them fiduciary obligations that run to the firm as a whole and not to any particular team member, corporate law reinforces and supports an essential economic role played by hierarchy in general, and by corporate boards of directors in particular.").

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turn to common shareholders."[24] Similarly, Richard Posner states, "Managers are deemed fiduciaries of their shareholders . . . ."[25] Any number of additional commentators might be cited to the same effect.[26]

Challenging the orthodox generalization, Blair and Stout focus on the two elements of corporate law that most obviously appear to reflect a shareholder primacy foundation. These are the shareholders' exclusive rights to prosecute derivative suits for breach of fiduciary duty and to elect the board of directors. A close look at their analysis suggests that, at best, TPM's claim of descriptive validity is overstated.

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[24] Michael P. Dooley, Fundamentals of Corporation Law 97 (1995).

[25] Richard A. Posner, Economic Analysis of Law 460 n.1 (5th ed. 1998).

[26] See, e.g., Bainbridge, supra note 22, at 1424–25 ("At least in Delaware, the shareholder wealth maximization norm thus remains a more accurate description of the law than any of its competitors."); Bernard Black & Reinier Kraakman, A Self-Enforcing Model of Corporate Law, 109 Harv. L. Rev. 1911, 1921 (1996) ("The efficiency goal of maximizing the company's value to investors remains, in our view, the principal function of corporate law."); Kenneth B. Davis, Jr., Discretion of Corporate Management To Do Good at the Expense of Shareholder Gain—A Survey of, and Commentary on, the U.S. Corporate Law, 13 Can.-U.S. L.J. 7, 8 (1988) ("[M]aximization of shareholder value is the polestar for managerial decisionmaking."); D. Gordon Smith, The Shareholder Primacy Norm, 23 J. Corp. L. 277, 278 (1998) ("[S]hareholder primacy is manifest throughout the structure of corporate law . . . ."). Henry Hansmann and Reinier Kraakman observe an international convergence around the shareholder primacy, principal-agent model of corporate law, referring to:

> [A] growing consensus . . . among the academic, business, and governmental elites in [European, American, and Japanese] jurisdictions . . . that the ultimate control over the corporation should be in the shareholder class; that the managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders; [and] that other corporate constituencies, such as creditors, employees, suppliers, and customers should have their interests protected by contractual and regulatory means rather than through participation in corporate governance . . . .

Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law 2–3 (Yale Law School Law and Economics Working Paper No. 235 & New York University Center for Law and Business Law and Economics Working Paper No. 013, Jan. 2000), available at http://papers.ssrn.com/paper.taf?abstract_id=204528. Correct or not, Hansmann and Kraakman's argument is interesting for its apparent inconsistency with comparative corporate law scholarship that emphasizes "path dependent" differences across national boundaries. See, e.g., Lucian Ayre Bebchuk & Mark J. Roe, A Theory of Path Dependence in Corporate Ownership and Governance, 52 Stan. L. Rev. 127 (1999).

1. The Shareholders' Derivative Suit

Blair and Stout point out that a number of procedural hurdles impede the effectiveness of derivative actions.[27] They interpret these rules as designed to protect the board's independence from shareholder control so that it can perform TPM's mediating function.[28] This reading is problematic because it suggests that a single doctrinal area of corporate law simultaneously pursues mutually inconsistent purposes: On the one hand, the law erects a mechanism constructed to render the board accountable to the shareholders while, on the other, it immobilizes that mechanism to insulate the board from shareholder oversight. A more coherent explanation of the various rules limiting access to derivative suits is the orthodox view that these measures reflect legitimate concerns about the costs of groundless lawsuits motivated solely by a quest for plaintiffs' attorneys' fees.[29] Like the derivative action itself, these limitations are justifiable by reference to shareholder financial interests because the costs of abusive litigation fall most heavily on the shareholders as a group due to their status as residual claimants. Corporate law thus attempts to balance the potential benefits to shareholders of an effective device for enforcing fiduciary duties against the potential costs to shareholders of abuse. The various rules aimed at striking this balance are entirely consistent with a shareholder primacy understanding of derivative litigation.[30]

Blair and Stout also note that under certain circumstances creditors may bring derivative proceedings.[31] This is supposed to indicate that shareholders are not the only corporate constituency that can insist on fiduciary protection. The possibility of derivative

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[27] See Blair & Stout, supra note 1, at 294.

[28] See id.

[29] See Roberta Romano, The Shareholder Suit: Litigation Without Foundation?, 7 J.L. Econ. & Org. 55, 61 (1991) (concluding that the results of empirical study suggest that "a significant proportion of shareholder suits are without merit").

[30] Speaking about the policy of judicial deference to board decisions to recommend dismissal of derivative litigation, two commentators note that the purpose of deference is to protect the shareholders as a group "against unwarranted interference in that process by one of their number. Although it is customary to think of the business judgment rule as protecting directors from stockholders, it ultimately serves the more important function of protecting stockholders from themselves." 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).

[31] See Blair & Stout, supra note 1, at 295.

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proceedings brought by creditors, however, does not compromise shareholder primacy because creditors gain the right to sue only when the corporation is insolvent.[32] Once assets no longer exceed liabilities, shareholders' equity is gone and creditors cannot count on being paid according to the terms of their contracts. Creditors have replaced the shareholders as residual claimants, and the board's fiduciary duty (of nonpreferment) turns to them. The possibility of derivative actions by creditors in insolvency simply recognizes that shareholders may, as a practical matter, be out of the picture. It makes no sense to worry about shareholder primacy in that event since there is no longer any conflict of interest between creditors and shareholders.

The more pertinent question is why shareholders alone enjoy standing to sue while the corporation is solvent. Here too, Blair and Stout's view—that shareholders act as proxies for all the various claimants to corporate assets[33]—is questionable. Shareholders are under no duty to bring suit in cases in which they have no interest. Suppose, for example, that the corporation has assumed additional indebtedness that has weakened the value of existing creditors' claims against corporate assets.[34] Shareholders need not bring suit to vindicate the interests of the injured bondholders and, as a practical matter, they have no incentive to do so because they stand to gain nothing from the exercise. In fact, shareholders may be the beneficiaries of the bondholders' predicament when, for example, a leveraged-buyout transaction is financed by a mountain of new debt.[35] In short, however strong a nonshareholder constituent's claim might be, shareholders have no legal duty, and may well have no practical incentive, to bring suit on its behalf. Their exclusive standing benefits nonshareholders only when shareholders stand to gain too, and then only incidentally rather than by design.

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[32] No court has endorsed a creditor's right to sue derivatively on behalf of a solvent corporation. The theoretical possibility of such a suit is based on a trial court's remarks about the scope of management's fiduciary duty shifting from shareholders to creditors when the corporation is "in the vicinity of insolvency." Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., Civ.A. No. 12,150, 1991 Del. Ch. LEXIS 215, at *108 & n.55 (Dec. 30, 1991).

[33] See Blair & Stout, supra note 1, at 293.

[34] See, e.g., Metropolitan Life Ins. Co. v. RJR Nabisco, 716 F. Supp. 1504 (S.D.N.Y. 1989).

[35] This was the situation in the *MetLife* case. See id.

If there is incidental benefit, it is simply a function of corporate law's specification of the shareholders as residual claimants within the corporation's financial structure. When shareholders have an incentive to bring derivative actions, the entire corporation stands to benefit from a successful outcome because there will be more assets in the corporate treasury than would otherwise have been the case. If nonshareholders are better off, it is only because shareholders, being residual claimants, gain nothing in such cases unless senior claimants do too. Benefits to nonshareholders from successful derivative actions are the accidental by-products of their place in the corporation's financial structure rather than an expression of policy grounded in TPM.

In fact, it is not necessarily the case that senior claimants will gain from successful shareholders' derivative suits. Nonshareholder benefits may turn out to be illusory. The fact that recovery is paid to the corporation does not necessarily mean that nonshareholders are better off than they would have been if the payment had gone directly to the shareholders.[36] Creditors' claims are fixed by contract: Unless contractually specified, there is no right to share in the corporation's net assets. While there is a sense in which all stakeholders are at least marginally better off as the corporation's wealth increases (because their claims are that much more secure), corporate law does nothing to ensure that nonshareholders rather than shareholders will actually realize some portion of the gain. To the contrary, a solvent corporation may distribute the entire recovery to the shareholders in the form of dividends.[37] There is no requirement that nonshareholders receive some portion or even that it be retained in the corporate treasury as a sort of insurance fund against future insolvency. This is a further reason to question the notion that the shareholders' derivative suit exists for the benefit of nonshareholders as much as it does for shareholders.

[36] Cf. Blair & Stout, supra note 1, at 295 (claiming that damages from a derivative suit that are paid to the corporation benefit all of the corporation's stakeholders).

[37] More specifically, a corporation may make such a distribution as long as it will not result in insolvency. See, e.g., Model Bus. Corp. Act § 6.40(c) (1997). Statutory restrictions on dividend payment reflect the legal principle that shareholders, being residual claimants, may not distribute corporate funds to themselves to the prejudice of existing creditor claims.

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If the goal of corporate law is to free the board to divide rents from production among the various team members, one would more readily expect that *all* constituencies would lack standing to sue. Or, at least, one would expect that there would be a set of rules constituting shareholders as agents of the various nonshareholder constituencies who might have reason to assert claims against the board. Blair and Stout acknowledge that current law makes it possible for shareholders to exert pressure on management to promote the shareholders' own interests, potentially at the expense of other stakeholders.[38] That is precisely the reason why corporate law gives them a monopoly over the derivative suit coupled with the freedom to use it when it serves shareholder interests and not to use it when it does not. However ineffective this device might be in practice, it is very difficult to justify in terms of TPM.

2. The Business Judgment Rule

Blair and Stout also find TPM at work in the substantive fiduciary duties that are enforceable by derivative actions. Although the duties of loyalty and care purportedly limit directors' discretion, the authors argue that "case law interpreting the business judgment rule often explicitly authorizes directors to sacrifice shareholders' interests to protect corporate constituencies."[39] The few cases cited in support of this proposition offer ouly doubtful support.[40] More

[38] See Blair & Stout, supra note 1, at 297 (indicating that shareholders may "use the threat of suit to extract concessions from directors").

[39] Id. at 303 (italics omitted).

[40] Blair and Stout cite Theodora Holding Corp. v. Henderson, 257 A.2d 398 (Del. Ch. 1969), as allowing directors to make charitable donations of corporate funds. See Blair & Stout, supra note 1, at 303 & n.140. However, the court based this holding on a provision of the Delaware corporation statute that expressly authorizes charitable activity rather than on a general principle allowing directors to benefit nonshareholders at the expense of shareholders. See *Theodora*, 257 A.2d at 404–05 (citing Del. Code Ann. tit. 8, § 122(9) (1991)). Such provisions are included in all corporation statutes. See, e.g., Model Bus. Corp. Act § 3.02(13) (1997). Were it not for the general principle that directors should use their powers to promote shareholder wealth maximization, these statutory exceptions to the general rule would not be necessary. The court in *Theodora* also allowed the gift as being in the long-run interest of the shareholders, a common justification for corporate charity that is consistent with the shareholder primacy norm. See *Theodora*, 257 A.2d at 405. Blair and Stout point to Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 1968), as authorizing directors "to reject business strategies that would increase profits at the expense of the local community." Blair & Stout, supra note 1, at 303. That court's opinion, however, merely

telling would be a case in which the board was presented with a clear trade-off between the interests of shareholders on the one hand and those of some nonshareholder constituency on the other. Outside of the corporate takeover context, however, Blair and Stout cite no decision holding that the business judgment rule would shield the board of a public corporation from liability if it frankly chose to privilege nonshareholder interests over those of shareholders for reasons unrelated to profit maximization.[41]

The one area of corporate law in which judicial opinions have expressed the notion that directors may temper their regard for shareholder interests with attention to those of nonshareholders is in the recently developed Delaware jurisprudence regarding defensive responses to hostile takeovers. As Blair and Stout point out, the Delaware Supreme Court has expressly authorized directors to consider, among a number of factors, "the impact on the 'constituencies' other than shareholders (that is, creditors, customers, employees, and perhaps even the community generally)."[42] Within a year of that holding, however, the same court qualified its state-

holds that the plaintiff failed to plead sufficient facts to establish that the policies at issue were "contrary to the best interests of the corporation and the stockholders." *Shlensky*, 237 N.E.2d at 780. In any event, the corporation at issue in *Shlensky* was closely held, a situation to which TPM concededly does not apply. See Blair & Stout, supra note 1, at 281. Blair and Stout cite Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., Civ. A. No. 12,150, 1991 Del. Ch. LEXIS 215 (Dec. 30, 1991), for the proposition that directors enjoy the authority "to avoid risky undertakings that would benefit shareholders at creditors' expense." Blair and Stout, supra note 1, at 303. However, by its own terms, that aspect of the holding in *Credit Lyonnais* applies when a corporation "is operating in the vicinity of insolvency." *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at *108. Blair and Stout's reference to the *Time* case is to the trial court's opinion (*Theodora*, *Shlensky*, and *Credit Lyonnais* are also trial court opinions). See Blair & Stout, supra note 1, at 304 & n.146. The Delaware Supreme Court's affirmance, however, does not rely on the board's desire to preserve "Time culture" as a justification for opposing Paramount's hostile takeover bid. See Paramount Communications v. Time, Inc., 571 A.2d 1140 (Del. 1989). The analysis of defensive responses to hostile takeovers in Cheff v. Mathes, 199 A.2d 548 (Del. 1964), the last of the five cases that Blair and Stout cite, see Blair & Stout, supra note 1, at 304 & n.146, has been superseded by later decisions, particularly Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

[41] Rather than presenting their argument as a reading of corporate law doctrine as it has been articulated in judicial opinions, Blair and Stout might make a different claim here: Despite corporate law's asserted commitment to shareholder interests, *in practice* doctrines like the business judgment rule allow directors the freedom to benefit nonshareholders at the shareholders' expense. For evaluation of this argument, see infra Part II.B.

[42] *Unocal*, 493 A.2d at 955.

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ment, restricting, if not eliminating, the board's power to sacrifice shareholder interests for the sake of nonshareholder considerations. In the *Revlon* case, the court declared that concern for nonshareholder constituencies "is limited by the requirement that there be some rationally related benefit accruing to the stockholders."[43] Further, the *Revlon* opinion stated that when breakup of a corporation becomes inevitable, the board's only duty is "maximization of the company's value at a sale for the stockholders' benefit,"[44] regardless of potential harmful effects on nonshareholders. Thus, at the moment in a corporation's history when nonshareholders are most vulnerable, facing involuntary forfeiture of firm-specific investments and other losses, the board is required to look solely to the shareholders' interest in obtaining the highest possible price for their stock, and it lacks any authority to structure a lower-priced deal that would protect or compensate nonshareholders. At best the Delaware cases interpreting directors' fiduciary duties in the specific area of defensive measures to hostile takeovers display an ambivalent commitment to shareholder primacy.[45] This ambivalence in one area of corporate law is a far cry from the clear and pervasive endorsement of TPM asserted by Blair and Stout.

[43] Revlon, Inc. v. MacAndrews & Forbes Holdings 506 A.2d 173, 176 (Del. 1985). This case starkly presented a conflict between the interests of shareholders on the one hand (in receiving an attractive takeover premium) and those of a class of nonshareholders (noteholders), who stood to gain from an alternative transaction that would be less valuable to the shareholders. See id. at 182.

[44] Id. at 182. In a later decision, the Delaware Supreme Court extended their *Revlon* auction duty to transactions involving transfers of control. See Paramount Communications v. QVC Network, 637 A.2d 34 (Del. 1994).

[45] Subsequent Delaware cases on takeover defenses reveal an ambiguity similar to that exhibited by the juxtaposition of *Unocal* and *Revlon*. The Delaware Supreme Court's decision in *Time* seemed to grant broad authority to the board to resist a hostile takeover despite shareholder preferences, see Paramount Communications v. Time, Inc., 571 A.2d 1140 (Del. 1989), but a subsequent opinion reiterated the *Revlon* duty to maximize shareholder return under certain circumstances. See Paramount Communications v. QVC Network, 637 A.2d 34 (Del. 1994). For discussion of the Delaware judiciary's ambivalence toward shareholder primacy in the area of hostile takeovers, see Johnson, supra note 7; Millon, Theories of the Corporation, supra note 7.

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3. Shareholders' Voting Rights

Shareholders enjoy the exclusive right to elect the corporation's directors and to vote on other fundamental corporate changes.[46] As a practical matter, however, management determines the outcome of the annual election and typically gets its way on other shareholder votes too.[47] This is due in large part to the presumption of legitimacy that shareholders accord corporate management; if shareholders lose faith in management the ordinary response is simply to sell their stock and reinvest the proceeds elsewhere.

Rules of corporate law also contribute to the inefficacy of voting rights. Ordinarily, the corporation bears management's proxy solicitation expenses in both routine solicitations and in connection with proxy contests. In contrast, shareholders who seek to override management's preferences by communicating their views to the rest of the electorate and soliciting proxies must pay these costs themselves and will receive reimbursement of proxy-contest expenses only if the insurgency is successful.[48] Despite the obvious disincentive to potential challengers, this feature of corporate law does not indicate a lack of commitment to shareholder primacy.[49] To the contrary, it represents a pragmatic recognition that allowing shareholders free rein to mount challenges to incumbent management at the corporation's expense would result in potentially weighty costs borne by all the shareholders, even if there is no offsetting benefit. Tying reimbursement to success reflects a reasonable effort to balance the potential costs of corporate-sponsored politicking by disgruntled shareholders against the benefits that can flow from challenges that earn substantial shareholder support.[50] Like the legal limitations on shareholder derivative suits, corporate law's limited support for shareholder proxy solicitations

[46] Preferred shareholders or even creditors may enjoy voting rights under some circumstances, but only to the extent that specific contractual provisions supplement corporate law's default rule of shareholder exclusivity.

[47] See, e.g., Bernard Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 521 (1990) ("The managers—current officers and directors—pick the directors, and the shareholders rubber-stamp the managers' choices.").

[48] See Lucian Arye Bebchuk & Marcel Kahan, A Framework for Analyzing Legal Policy Toward Proxy Contests, 78 Cal. L. Rev. 1071, 1108–10 (1990).

[49] Cf. Blair & Stout, supra note 1, at 310–12.

[50] Cf. Bebchuk & Kahan, supra note 48, at 1110–22 (arguing for partial reimbursement of successful insurgents).

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can be understood in terms of shareholder financial interests. As such, it is consistent with a shareholder primacy explanation of voting rights.

Blair and Stout further argue that shareholders benefit the corporation's various nonshareholder constituencies when they exercise their voting rights,[51] even though shareholders are free to vote entirely according to their own sense of self-interest.[52] The argument is analogous to their view that shareholders' derivative actions are justified by their potential to enhance the well-being of all stakeholders simultaneously. Sometimes this simply is not the case. The shareholders' exclusive right to vote on certain fundamental matters, including mergers,[53] sales of all or substantially all assets,[54] or dissolution,[55] may increase shareholder wealth but result in uncompensated losses for nonshareholders. Workers may lose their jobs in the aftermath of a transaction that benefits the shareholders, bondholders may find their investments devalued,[56] and preferred shareholders may have accrued, undeclared dividends wiped out.[57] In any of these cases, the shareholders' monopoly over the franchise cannot be justified in terms of nonshareholder interests; if corporate law were committed equally to all the members of the team, either all affected parties would have a right of approval or no one would. At the very least, under a TPM-based conception of the board's role, one might expect the board to have the power and the duty to veto shareholders' decisions that harm nonshareholder constituencies.[58]

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[51] See Blair & Stout, supra note 1, at 313–14.

[52] See, e.g., Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 53 A.2d 441, 447 (Del. 1947) ("[A] shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed his fellow shareholders.").

[53] See, e.g., Model Bus. Corp. Act § 11.03(a) (1997).

[54] See, e.g., id. § 12.02(a).

[55] See, e.g., id. § 14.02(a).

[56] See, e.g., Metropolitan Life Ins. Co. v. RJR Nabisco, 716 F. Supp. 1504 (S.D.N.Y. 1989) (concerning a merger following a leveraged tender offer resulting in the loss of value of bonds).

[57] See, e.g., Bove v. Community Hotel Corp., 249 A.2d 89 (R.I. 1969) (concerning a merger resulting in cancellation of accrued preferred stock dividends).

[58] Even when the shareholders elect a board or approve a transaction that enhances the corporation's profitability without violating nonshareholder interests, the benefit to nonshareholders such as creditors and employees is an incidental—and therefore

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Blair and Stout's final effort to explain the shareholders' voting rights monopoly emphasizes shareholders' inability to affect the division of rents through the contracting process in which employees and creditors routinely engage in their dealings with the corporation.[59] The suggestion seems to be that control or at least direct influence over board composition is a practical substitute for bargaining between shareholders and the board about rent allocation. From the TPM perspective, this argument proves too much. If that were the actual effect of shareholder voting rights, it would severely undermine the possibility of board independence and neutrality that TPM demands. In fact, of course, voting rights do not work this way. Senior management typically chooses the board and the prospect of an annual election directly influences board decisionmaking only in unusual situations of significant shareholder dissatisfaction or concentrated share ownership. Ordinarily, other mechanisms more directly shape the board's deferential posture toward shareholder interests.[60] Even so, the existence of shareholder voting rights as a device rendering the board accountable to the shareholders is not entirely trivial. If corporate law were to embody TPM's conception of the board as a mediating agency independent of all of the corporation's stakeholders, a self-perpetuating body exempt from any electoral pressure (as well as the threat of derivative suits and hostile takeovers) would make more sense than the current arrangement.

B. Doctrinal Inefficacy and Director Discretion

In my view, Blair and Stout's claim that current corporate law reflects TPM's conception of the board's role is at best problematic. It is true that corporate law's commitment to shareholder primacy and a principal-agent conception of the board's duty is not entirely unequivocal. The specter of corporations' vast economic power has been a feature of American political discourse for much of the past hundred years, and critics have often insisted that relentless dedication to shareholder financial interests can generate substantial social costs. Accordingly, corporate law has always

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accidental—by-product of a right exercised by shareholders entirely according to their own sense of self-interest.

[59] See Blair & Stout, supra note 1, at 314.

[60] See infra Part III.A.2.

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tempered its regard for shareholders with nonshareholder concerns, at least secondarily.[61] Nevertheless, legal doctrine—particularly in the centrally important areas analyzed by Blair and Stout—bears a stronger shareholder primacy imprint than an imprint of TPM.[62]

Blair and Stout might appear to be on firmer ground if they made a different kind of descriptive assertion. Whatever may be the content and stated purpose of corporate law's principal doctrines and procedures, the law in fact allows directors broad discretion to manage the corporation without pure devotion to shareholder interests. The procedural hurdles already mentioned (coupled with the business judgment rule's hindrance of judicial scrutiny) limit the efficacy of the shareholders' derivative suit, and shareholders' voting rights impinge upon director preferences only in unusual situations. In other words, though corporate law pays lip service to shareholder primacy, it is actually ineffective when it comes to rendering management accountable to the shareholders. This doctrinal inefficacy, the argument would run, itself reflects a commitment to director discretion, which in this roundabout manner constitutes the board as independent TPM mediators.

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[61] Long-standing examples include statutory authorization of charitable donations, see, e.g., Model Bus. Corp. Act § 3.02(13) (1997), and creditor protection features of statutory restrictions on asset distributions. See, e.g., id. § 6.40. More recent developments include the nonshareholder constituency statutes, see supra note 6, and Delaware decisions allowing target company boards to resist hostile takeovers. See supra note 7.

[62] One might also point to other features of the law that are inconsistent with their interpretation. For example, only shareholders enjoy a right of access to corporate books and records. See, e.g., Model Bus. Corp. Act § 16.02 (1997). As one state supreme court recently explained, the rationale behind this right "is that those in charge of the corporation are merely agents of the shareholders, and a shareholder's right to inspect a corporation's books and records is only the right to inspect and examine that which is his own." Parsons v. Jefferson-Pilot Corp., 426 S.E.2d 685, 688 (N.C. 1993). This informational advantage would be surprising if the law were committed to equal standing for all team members in their dealings with the board. Moreover, even if a shareholder wanted to, he or she might be unable to exercise this right if the avowed purpose were to promote nonshareholder interests. If a request for inspection is part of an effort to persuade other shareholders to put pressure on management to forego profit maximization for the sake of competing considerations, some states impose a "proper purpose" requirement that allows management to deny access to corporate records and also to the list of shareholders. See, e.g., State ex rel. Pillsbury v. Honeywell, Inc., 191 N.W.2d 406, 410 (Minn. 1971) (defining "proper purpose" as "concern with investment return"). Delaware law has no proper purpose requirement.

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As a practical matter, directors may well enjoy the freedom to balance the interests of all the corporation's stakeholders in a manner more or less consistent with TPM. Corporate law thus has accommodated the "managerialist" model that emerged after World War II, according to which "[t]he board of directors' duties extend[ed] beyond assuring investors a fair return, to include a duty of loyalty, in some sense, to all those interested in or affected by the corporation."[63] There is anecdotal evidence that at least some directors still think of their jobs this way.[64] As long as a board can plausibly invoke the corporation's "long-term interests," it can pay regard to nonshareholder interests without incurring liability in a shareholders' derivative suit, even though shareholders might insist they would profit from an alternative course of action. Directors probably have substantial freedom to pursue policies of this sort without significant risk of a shareholder electoral insurgency, as long as the corporation continues to earn at least a reasonable profit.

Although doctrinal inefficacy may allow board attention to nonshareholders despite the law's formal allegiance to shareholder primacy, it does not follow that corporate law therefore mandates TPM's conception of the board's role. The very discretion that allows corporate boards to pay attention to nonshareholder as well as shareholder interests also allows them to pursue shareholder value with relentless disregard for social costs. By the 1980s, developments like global competition, increasingly assertive and powerful institutional investors, and financial innovations that facilitated a dynamic hostile takeover market had disrupted the generous business climate of the 1950s and 60s.[65] Essentially the same legal framework that supported the managerialist model now permits corporate management to respond to incentives pushing them in the direction of shareholder wealth maximization.[66] Despite the doctrine's apparent shareholder primacy focus, corporate

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[63] William T. Allen, Our Schizophrenic Conception of the Business Corporation, 14 Cardozo L. Rev. 261, 264 (1992).

[64] See Jay W. Lorsch, Pawns or Potentates: The Reality of America's Corporate Boards 41–49 (1989) (describing directors' outlook that embraces regard for nonshareholder as well as shareholder interests).

[65] See Allen, supra note 63, at 264–65.

[66] For further discussion of this development, see infra Part III.A.2.

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law may be flexible enough in practice to allow the board to act like TPM's independent mediator, but the freedom that makes this possible also permits a dedication to shareholder value that is inconsistent with TPM. Corporate law's inefficacy thus does not reflect a commitment to TPM.

C. TPM as a Normative Theory

At best, Blair and Stout overstate the extent to which important features of corporate law already reflect TPM's rejection of shareholder primacy. Even if the descriptive assertion is flawed, however, TPM could still be read as a normative model. As such, it would support legal reforms aimed at strengthening the board's independence from the corporation's various constituencies. TPM would also justify a new conception of board responsibility centered on responsiveness to the interests of nonshareholders as well as shareholders.

TPM provides a strong argument for reforming corporate law to promote the board's independence from senior management, which typically handpicks nonmanagement members of the board. The shareholders' role then is the formality of ratification through the voting process.[67] Except in times of crisis, outside directors adopt a posture of deference toward the CEO rather than attempting to actively perform a monitoring role.[68] Accordingly, boards may be insufficiently vigilant in policing management's pursuit of its own selfishly defined preferences, including preferences for excessive compensation or for leisure. With its emphasis on the board's role as independent mediator among all the corporation's stakeholders, TPM offers a compelling reason to liberate the board from management's control. Needless to say, efforts to render the board more directly accountable to particular constituencies would also be inappropriate.

TPM also provides support for a different kind of corporate law reform. Critics of shareholder primacy have argued that the board ought to be responsive not only to shareholders but also to nonshareholders whose well-being depends on the board's decisions. This has been the thrust of progressive or communitarian corpo-

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[67] See supra note 47.

[68] See Lorsch, supra note 64, at 91–96.

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rate law scholarship.[69] From this perspective, TPM offers a potent argument against the shareholder primacy conception of the board's responsibility and would support reform of the various legal mechanisms that now, however imperfectly, aim to render the board accountable primarily to the shareholders. The remainder of this Essay turns to this important normative question. The aim is to consider carefully whether TPM's apparent rejection of shareholder primacy actually offers anything of value to nonshareholder corporate constituencies.

III. TPM AND THE BOARD'S DUTY TO NONSHAREHOLDERS

A. The Allocation Problem

1. TPM's "Political" Solution

According to TPM, the board's role as independent mediator is to divide the revenues (or economic rents) flowing from joint production among the various contributors of inputs to the production process.[70] Contributors obviously need to receive a return equal at least to their opportunity costs; otherwise they will be unwilling to continue to participate and the firm sooner or later will fall apart. Furthermore, a firm that develops a reputation for underpayment will be unable to attract potential team members. If production yields revenues in excess of the participants' opportunity costs, however, an independent board faces a virtually infinite array of choices about how to allocate shares of this surplus among team members.

The allocation problem often arises when a corporation is doing well. How are rents to be divided among shareholders and employees, for example?[71] A corporation may face a different kind of

[69] For a collection of articles representative of this critical approach, see Progressive Corporate Law (Lawrence E. Mitchell ed., 1995). See also sources cited supra notes 6, 7, and 20 and infra note 107 (articles by Millon, Mitchell, Johnson, and O'Connor).

[70] See Blair & Stout, supra note 1, at 276–77.

[71] Under perfect competition, management has no discretion to divide rents between shareholders and workers. Vigorous product market competition forces a corporation to price its output at cost; workers and shareholders therefore are compensated according to market rates, leaving no excess revenues. In fact, however, even firms subject to significant competitive pressures that hire workers in highly competitive labor markets typically exhibit a wide variation in the wages paid to workers in a single occupation. See Bruce E. Kaufman, The Economics of Labor Markets 244 (4th ed.

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challenge when it is struggling. Suppose one among a corporation's several plants cannot produce sufficient value even to pay its workers their opportunity wages. Should the board continue to operate the plant, subsidized by other, more productive plants? The subsidy, of course, is paid for by the workers at those other plants, who otherwise might receive a higher wage, or by the shareholders, who otherwise might receive a higher return on their invested capital, or, more likely, by both. Alternatively, the board might decide simply to close the plant. In that case, the displaced workers lose not only their incomes, which in theory can be replaced, but also the value of firm-specific human capital investments, which is not recoverable. There is, however, a corresponding benefit to the other, more productive members of the team, who are relieved of the burden of the underperforming workers. If the board chooses to close the plant, it must also decide whether to spend corporate funds on employee retraining and relocation in order to minimize transition costs. Compensation for lost human capital investments is also a possibility. These benefits to the discharged workers come at the expense of lower returns for other members of the workforce and for the shareholders. Thus, not only must directors make allocation decisions in times of prosperity, they must also do so when confronting losses.

Whether a corporation is flourishing or foundering, one intuitively supposes that allocation decisions should somehow be made according to the principle, "to each according to his or her due." That idea is not helpful by itself since it begs the question at issue: What constitutes just deserts? By its nature, the output of team production is nonseparable: It is typically impossible to identify after the fact the various team members' relative contributions to the

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1994) (discussing an empirical study of wages paid to secretaries in the Chicago area that found wide dispersion around the central mean). Imperfect information is one explanation. Wage variation suggests that corporations actually possess a significant measure of discretion in the allocation of production revenues between employees and shareholders, even though standard economic theory predicts a single wage for a single occupation under conditions of perfect competition. See id. at 241–44 (discussing the "law of one wage"). Moreover, a corporation that increases its productivity (through investment in new technology or economies of scale, for example) can generate surplus revenues, at least for some period of time. So too can a firm that offers a new, uniquely desirable product. As discussed more fully below, see infra Part III.B.2, wage increases may themselves generate increases in productivity, leaving both workers and shareholders better off as a result.

value generated by the finished product. The board must therefore use some measure other than the value of the participants' respective inputs in making its allocation decisions. Similarly, losses often occur for reasons that are complex and insufficiently clear for assignment of responsibility.

As developed by Blair and Stout, TPM offers the board no guidance as to how such decisions should be made. It provides no rules or principles by which to structure board decisionmaking; the model is agnostic on the question of just deserts. Instead, an independent third party—the board—has unconstrained authority to divide the pie. And in the absence of any constraints imposed by substantive norms, TPM envisions these allocation decisions as "political."[72] What does this imply in the way of actual behavior? The availability of markets presenting alternatives to investors of human and financial capital encourages the board to return at least the value of these opportunities to team members. Beyond those market-driven baselines, however, the board is expected to decide who gets what according to the pressures that the various claimants can bring to bear upon it. Blair and Stout are vague about the mechanics of this process, but suggest the use of several "political tools," including "vote trading, coalition formation, public relations campaigns, organizing to reduce obstacles to collective action, and appeals to regulatory agencies and congressional investigative committees."[73] The point seems to be that the participants can use these tools to threaten, cajole, or persuade the board to respond to their demands for larger shares of surplus (or smaller shares of losses) at the expense of their fellow team members. It is, in other words, a matter of power rather than principle.[74]

Seeing the matter in this light reveals an important feature of the TPM. While it effectively asserts the need to free the board from the demands of shareholders and a legal regime that privileges their interests over those of the various other contributors to corporate production, it disclaims any insights into the fundamental

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[72] Blair & Stout, supra note 1, at 282–83, 323–26.

[73] Id. at 323.

[74] See Margaret M. Blair & Lynn A. Stout, Team Production in Business Organizations: An Introduction, 24 J. Corp. L. 743, 747 (1999) ("[T]he question of who gets what portion of the corporate surplus may be determined simply by relative political power.").

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practical and theoretical question of how the board should exercise its broad powers. By endorsing the adequacy of political outcomes, the model implicitly assumes that the board's role is to validate existing, exogenously determined power relationships among employees, shareholders, and other stakeholders. Moreover, TPM tacitly accepts the possibility that extralegal pressures might lead the board to behave no differently than it would if operating under the constraints of a shareholder primacy legal regime. Two difficulties result. First, Blair and Stout overlook the potential inefficiencies implicit in this feature of TPM. Second, they fail to offer any explanation or justification for their implicit rejection of a role for the board that might yield distributional outcomes other than those dictated by power. Before turning to these problems,[75] it is first necessary to consider how extralegal pressures affect board decisionmaking.

2. *Extralegal Constraints on Board Discretion*

If political pressure shapes the board's rent allocation decisions, the fortunes of shareholders and nonshareholders depend on their ability to exert leverage or otherwise persuade the board to look favorably on their claims. Employees and shareholders bring to this political contest bargaining leverage that is determined in part by supply and demand in the markets for their inputs. Under conditions of relative scarcity and relatively high demand, one party may find itself in a more or less advantageous position in relation to the other. Other institutional mechanisms (like labor unions) or techniques (such as coordination among owners of large blocks of stock) may enhance the ability of one team member to extract larger shares of surplus than would otherwise be possible. Social norms can also influence allocation decisions, as would, for example, a conventional assumption that boards are supposed to assign priority to shareholder interests.

The nature of the parties' involvement in the corporation also influences bargaining power, and here the effect is to tip the balance in the direction of the shareholders. To the extent workers have made firm-specific human capital investments, the very fact of their employment by the corporation may place them at a bargain-

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[75] See infra Parts III.B & III.C.

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ing disadvantage they would not be under if negotiating an employment agreement for the first time. Once they have invested in nontransferable knowledge and skills, the threat of defection loses value as a bargaining tool because departure entails forfeiture of the investment. Shareholders, in contrast, have an easy and much lower-cost exit option. If the board is unwilling to give them the return they demand, they can sell their stock and reinvest their capital elsewhere because no portion of their investment is firm-specific. (This is so regardless of whether the corporation has invested its equity capital in firm-specific assets.) If enough shareholders choose this course of action, share prices will fall, and market prices can fluctuate in any event, so their exit option is not cost-free. Nevertheless, even if share prices have dropped, sale is likely to be far less costly than defection by workers who must forfeit the entirety of their firm-specific human capital investments. Moreover, investors of financial capital can hedge against these losses by diversification, a strategy unavailable to investors of human capital.

Differences in the cost of exit are not the only advantages enjoyed by shareholders. The existence of a shareholder-driven market for corporate control is what gives their threat of exit its bite. Because shareholders alone enjoy the legal authority to elect (and remove) the board of directors, shareholders can back up their demands for higher returns by threatening to sell their stock (or to grant voting authority by proxy) to someone who will use voting control to install a new board. Workers and other nonshareholders cannot make those threats because they have no voting rights. Although expensive and less active (for the time being) than in its heyday in the late 1980s, the market for corporate control still presents a credible threat to incumbent boards. Current law provides directors broad leeway in defending against hostile tender offers, typically by deploying a so-called "poison pill."[76] However,

[76] See Moran v. Household Int'l 500 A.2d 1346 (Del. 1985) (allowing use of a poison pill to discourage hostile tender offer). Poison pills deter hostile acquisitions by rendering acquisition financially undesirable to the bidder in various ways. Because the target board retains the authority to redeem the pill, the board must agree to allow an acquisition to proceed before a bidder will go forward. Current Delaware law accords target company boards broad discretion to defend against hostile bids. See Paramount Communications v. Time, Inc., 571 A.2d 1140 (Del. 1990); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

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discretion is not unlimited,[77] and under certain circumstances target company boards are required to maximize share value by auctioning the corporation to the highest bidder.[78] Even in situations where the target board can resist without breach of its fiduciary duty, an insurgent can mount a proxy contest aimed at replacing the board with directors who will redeem a poison pill and allow a bid to proceed. Large blocks of stock in the hands of institutional investors can increase the likelihood of success.

Despite a downturn in takeover activity at the end of the 1980s and into the early 1990s, recent events indicate that the market for corporate control is alive and well.[79] This is important because it means that corporate directors who are insufficiently attentive to shareholder demands face a credible threat of removal. In the words of one commentator, "[d]irectors serve shareholder interests, 'or else,' as the saying goes."[80]

Even if Blair and Stout are correct in their conclusion that corporate law does not lead boards to favor shareholder interests, there is good reason to believe that the extralegal incentives discussed here are having that effect. The evidence strongly suggests that shareholders are winning the rent allocation contest. Since 1970, manufacturing productivity (output per hour) has more than doubled.[81] Shareholders have earned generous returns; since 1990 alone, for example, the Dow Jones Industrial Index has quadrupled in value.[82] Nevertheless, at the lower end of the income scale, presumably populated more heavily by noninvestors, the gains have

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[77] Under the *Time* and *Unocal* decisions, resistance will not be allowed if a hostile bid is non-coercive and target management is unable to plausibly assert that continued independence is in the strategic interests of the corporate enterprise. See *Time*, 571 A.2d at 1153–54.

[78] See Paramount Communications v. QVC Network, 637 A.2d 34 (Del. 1994); Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986).

[79] See John C. Coates IV, Measuring the Domain of the Mediating Hierarchy: How Contestable Are U.S. Public Corporations?, 24 J. Corp. L. 837, 855–59 (1999); see also Robert Comment & William Schwert, Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures, 39 J. Fin. Econ. 3 (1995). According to one count, there were 57 successful hostile takeovers in 1999. See Block Bounces Back, Am. Law., Apr. 2000, at 74.

[80] Coates, supra note 79, at 859.

[81] See U.S. Census Bureau, U.S. Dep't of Commerce, Statistical Abstract of the United States 1999, at 442, tbl. 695 (119th ed. 1999) (presenting data for the period from 1970 to 1998).

[82] See id. at 534, tbl. 840.

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not been nearly as impressive. From 1970 to 1997, family incomes at the twentieth percentile grew by less than 4% and those at the fortieth percentile by only 11.3%.[83] This trend continues. During the last quarter of 1999, factory productivity grew by 10.7%, while hourly compensation rose only 4.3%.[84] Meanwhile, the stock market continues its remarkable advance and the gap between rich and poor continues to widen.[85] Data like these imply that shareholders are reaping the lion's share of gains in corporate productivity and suggest that they wield greater influence over the board of directors than do workers.

Whether corporate boards are independent of shareholder control as a matter of law, they evidently are not independent as a matter of fact. To the extent that rent allocation decisions depend on politics rather than law, shareholders possess substantial leverage that privileges them in relation to workers and other stakeholders. These extralegal advantages may be more effective than a legal regime that imperfectly accords priority to the claims of shareholders. As discussed in the next sections, directors' deference to shareholder interests has important practical implications both for efficiency and for the distribution of wealth between shareholders and nonshareholders.

B. Efficiency Implications of the Board's Allocation Decisions

1. The Costs of Rent-Seeking

A principal advantage of TPM's conception of the board as an independent mediator among the various claimants to the firm's revenues is said to be the reduction of the costs that otherwise flow from the parties' efforts to maximize their shares of the pie.[86] These

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[83] See id. at 479, tbl. 751. Those at the top of the scale have realized a gain of over 45%. See id. All numbers are adjusted for inflation.

[84] See John M. Berry, Productivity Propels Economy: Worker Output Keeps Growing, Wash. Post, Feb. 9, 2000, at A1.

[85] The income gap in this country grew steadily wider during the last quarter of the previous century. Wage inequality among male workers between the top and bottom deciles increased from a ratio of 3.59 in 1973 to 4.45 in 1996. See Jared Bernstein & Lawrence Mishel, Has Wage Inequality Stopped Growing?, Monthly Lab. Rev., Dec. 1997, at 3. For discussion of increasing inequality of wealth and income and its causes, see Edward N. Wolff, How the Pie is Sliced: America's Growing Concentration of Wealth, Am. Prospect, Summer 1995, at 58.

[86] See Blair & Stout, supra note 1, at 278.

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costs can arise from ex ante efforts to draft contracts as well as from ex post squabbling and opportunistic rent-seeking. A board of directors with sole authority to allocate shares of the joint product has the potential to reduce or even eliminate these costs. To do this, however, the board must be sufficiently independent of external pressures so that rival team members would have no reason to expend resources attempting to influence the board's allocation decisions. Otherwise, the rent-seeking arena simply shifts from competition among the claimants themselves to equally costly competitive efforts to influence the board.

Far from insulating the board from external pressures, TPM's political solution to revenue division actually rewards costly rent-seeking behavior. As envisioned by Blair and Stout, the corporation's participants employ a variety of techniques to exert pressure on the board.[87] The costs generated by these activities could be even greater than they would be under a legal regime that structures board decisionmaking, because legal limits on board discretion can reduce incentives to attempt to extract outcomes that are proscribed by law. More concretely, a legal regime that limits nonshareholder claims to contractually defined payouts (leaving the residue for the shareholders) discourages workers from attempting to extract a higher rate of return on their contributions to production. At the same time, shareholders have no incentive to seek rents that the board is contractually obligated to distribute to workers. In contrast, if the board owes no legal duty to any corporate constituency, everything is potentially up for grabs and everyone therefore stands to gain from efforts to influence the board's allocation decisions—no one can afford to stand on the sidelines. If rent-seeking activities are sufficiently vigorous (which in turn depends in part on how large the likely payoffs are), it is possible that the aggregate net benefits to team members under TPM could be less than they would be under a legal regime of shareholder primacy because the value of each person's share of the pie would be reduced by the costs required to obtain it.

If TPM is to benefit all team members by lessening the costs of rent-seeking, liberation from legal rules rendering the board accountable to particular constituencies is not enough. In addition to

[87] See supra text accompanying note 73.

freedom from the threat of legal liability for its rent allocation decisions, the board also would need to be free from extralegal, political pressures to favor the demands of some constituencies over others because its susceptibility to these pressures generates the incentives to engage in rent-seeking. Is it possible to conceive of a set of legal rules capable of establishing this state of ivory tower autonomy? At the very least, the board would need to be fully protected from shareholder efforts to influence its behavior through the threat of removal by hostile tender offers or proxy fights. In addition, boards would need to be self-perpetuating, rather than subject to selection by shareholders or senior managers.[88] Senior management should also be excluded from board membership as long as executive compensation includes elements (such as stock options) that align management's interests with those of the shareholders. In other words, if one of TPM's virtues is the abatement of rent-seeking, it does not go far enough by focusing solely on legal independence from shareholder control.

2. *Potential X-Efficiency Gains*

A regime relying on rent allocation dictated by political pressure may also be inefficient for a different reason. As economist Harvey Leibenstein has argued, there appears to be a linkage between worker compensation and worker productivity.[89] An important determinant of a firm's productivity is the amount of effort that workers are willing to exert in the performance of their jobs. While monitoring compliance with established standards can yield baseline levels of productivity, whether workers will work harder than the baseline remains within their own discretion.[90] Workers may choose to expend the least amount of effort necessary to avoid discharge, or they may work to their fullest capacity on behalf of the

[88] Lawrence Mitchell makes this point for essentially the same reason. See Mitchell, Critical Look, supra note 20.

[89] See Harvey Leibenstein, Inside the Firm: The Inefficiencies of Hierarchy (1987) [hereinafter Leibenstein, Inside the Firm]; see also Harvey Leibenstein, Beyond Economic Man: A New Foundation for Microeconomics 95–117 (1976) [hereinafter Leibenstein, Beyond Economic Man] (arguing that the "material rewards for effort must be included as part of the utility of effort").

[90] See Leibenstein, Inside the Firm, supra note 89, at 99–102.

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firm's interests, or their effort level may fall somewhere in between.[91]

Management's decisions about compensation and working conditions have a significant impact on worker motivation. Here, too, choices must be made. Management can offer a package of pay and working conditions that is generally equivalent to that available from other employers for similar work; it can be more generous, providing the best deal possible under the firm's circumstances; or it can attempt to get away with the bare minimum needed to prevent mass defection.[92]

Following Leibenstein, it is possible to model the interactions among these choices as a prisoner's dilemma game.[93] Leibenstein describes the game as involving workers and management, employing the standard assumption that management's job is to act on behalf of the shareholders. Because TPM conceives of management as operating independently rather than as an agent of the shareholders, Leibenstein's prisoner's dilemma framework can be recast to substitute the shareholders themselves for management. The game therefore involves shareholder decisions about how large a share of the pie they are willing to allow the board to allocate to the firm's workers. Shareholders thus must decide whether to put pressure on the board to obtain for themselves the greatest possible portion of production revenues that will not trigger worker defection. Alternatively, they may allow a generous share to go to the workers, demanding for themselves a bare minimum return on their investments. The third option is some point intermediate between these poles.

From the perspective of both workers and shareholders, the optimal outcome is one in which workers put forth extraordinary effort in return for the best possible compensation package. Greater firm productivity makes it possible for workers to earn higher wages and allows shareholders to realize higher profits than would otherwise be available.[94] As Leibenstein illustrates with his prisoner's dilemma framework, however, even though this result is optimal for both workers and shareholders, it is unlikely to occur

[91] See id. at 48–49.
[92] See id. at 49.
[93] See id. at 48–58.
[94] See id. at 55.

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as a result of arms' length bargaining between the parties. If workers see that shareholders are willing to allow a high wage, they can maximize their utility by low effort in return for that higher wage. At the same time, low effort protects workers from the risk that the shareholders will end up insisting on low wages and high profits after all, and attempt to grab for themselves the productivity gains that would flow from high effort. Shareholders assess the situation similarly. If they allow workers to receive a high wage, workers may respond with low effort; the low wage option reduces the costs of low effort. Rational choice thus would appear to drive both workers and shareholders toward the low-effort, low-wage result.[95] In fact, Leibenstein argues, effort and wage conventions (or social norms) shape outcomes that are superior to the prisoner's dilemma result, but these conventions nevertheless tend to be suboptimal.[96] The result is less than optimal productivity, which Leibenstein has termed "internal inefficiency" or "X-inefficiency."[97]

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[95] See id. at 49–50.

[96] See id. at 77–97. On the likely suboptimality of conventions in general, Leibenstein writes:

> Many conventions are probably established without careful calculation of their optimality. Furthermore, some of the considerations that enter into "creation" of a convention are noneconomic. Once established, conventions have an inertial tendency to persist that discourages individual adaptations to changing circumstances, which again makes suboptimality likely.

Id. at 71–72. Economists have sought to explain how optimal solutions in prisoner's dilemma games can arise even without external enforcement where breach of implicit agreements to cooperate can be punished in subsequent iterations of the game. See Robert Axelrod, The Evolution of Cooperation (1984) (describing the "tit-for-tat" strategy). However, even under this model, cooperation can unravel as the parties approach end-game scenarios. Furthermore, economic models generally leave unclear the question of why the parties might choose to cooperate in the first place. As Marleen O'Connor has noted, rational choice theory alone cannot fully explain cooperative behavior. The role of mutual trust must also be taken into account, a concept that is hard to grasp fully by reference solely to utility maximization. See O'Connor, supra note 20, at 928–29. Lawrence Mitchell's thoughtful work on the importance of trust in business organizations draws insightfully on social psychology, philosophy, and organizational behavior literature to demonstrate that trust cannot be understood in terms of instrumental self-interest. See Lawrence E. Mitchell, Trust and Team Production in Post-Capitalist Society, 24 J. Corp. L. 869 (1999); Lawrence E. Mitchell, Trust. Contract. Process., *in* Progressive Corporate Law, supra note 69, at 185.

[97] Leibenstein, Beyond Economic Man, supra note 89, at 29–47. Leibenstein's *Inside the Firm*, supra note 89, is a fully elaborated analysis of the X-inefficiency phenomenon in the context of an organizational theory of the firm.

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TPM's reliance on political pressure as the basis for rent allocation disregards the potential impact of the board's decisions on X-efficiency.[98] As a neutral third party, the board may have the potential to break the prisoner's dilemma impasse of distrust and move workers and shareholders closer to an optimal mix of effort, wages, and profits. For example, an independent board committed to enhancing the firm's productivity might offer wage increases subject to review and downward adjustment if no increase in productivity is observed. Promises of "fair" compensation that would confront credibility difficulties if made by shareholders who stand to gain from opportunism could have a meaningful effect on worker behavior if made by a board that has no interest of its own at stake. Ex ante guarantees of high wages in return for greater effort may result in shirking and free-riding, but worker perceptions of a reliable connection between pay and productivity could encourage workers to monitor each other's performance. More importantly, the experience of placing themselves in positions of vulnerability and escaping unscathed, combined with the higher returns generated by cooperation, may result in conventions or habits of high effort that take on normative power and thereby reduce the incidence of employee opportunism and the need for monitoring.[99] At the same time, experience should reduce shareholder skepticism about the benefits of higher wages. In other words, an independent board may be able to facilitate development of trusting relationships between workers and shareholders that would not arise spontaneously. Workers who trust shareholders can work harder in the expectation that they will receive appropriate compensation; likewise, shareholders can count on higher effort for higher pay.[100]

For the board to play a facilitating role in cultivating trust between workers and shareholders, both parties must be willing to trust the board itself. They must believe in its neutrality; the board must not be perceived as acting solely or primarily on behalf of

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[98] See Mark A. Lutz, Some Thoughts on Corporate Law and Responsibility 3 (Jan. 2000) (unpublished paper, on file with the Virginia Law Review Association).

[99] For discussion of the possibility that new effort conventions, internalized by the workforce, might reduce the need for monitoring, see Leibenstein, Inside the Firm, supra note 89, at 74.

[100] Cf. O'Connor, supra note 20, at 955 (proposing that the board's fiduciary duty run to employees as well as shareholders to promote "cooperative corporate cultures by allowing employees to rely upon systems of trust").

one party or the other. Otherwise, a party's distrust of the board will have the same effect as mutual distrust between the parties themselves, resulting in unwillingness to make the commitments necessary to achieve consummate cooperation. One apparent virtue of TPM's conception of an independent board is the possibility that the players might be willing to accord the board a measure of trust that they are otherwise unwilling to extend to each other.

If, however, the board's rent allocation decisions are determined solely by political pressure, X-efficiency gains flowing from cooperation are likely to be unattainable. Shareholders motivated by assumptions about the risk of worker opportunism may use their power to prevent the board from offering higher wages in return for higher effort. This is especially likely where the potential benefits are uncertain to begin with, and not readily demonstrable ex ante. Where long-run net benefit could be shown with some plausibility, some investors (including large institutions) might still prefer to receive a higher rate of return more immediately. Equally important, regardless of actual shareholder attitudes, workers might well refuse to put forth higher effort if they assume that their work will go unrewarded by a board subject to shareholder control. Conventional distrust of shareholder motives coupled with a perception of shareholder control can result in distrust of a board even in the absence of a shareholder primacy mandate. TPM's conception of the board as passive reactor to political power thus precludes a role for the board as agent for the promotion of X-efficiency. The result is lower returns for workers and shareholders alike.

As discussed above, complete independence from extralegal as well as legal pressures might reduce the costs of rent-seeking by removing the incentive to seek rents.[101] However, it is unlikely that independence alone would be sufficient to improve X-efficiency. While true independence might allay distrust of the board and make it possible for the board to facilitate mutual trust between shareholders and workers, independence alone would create no incentive for the board to do the hard work necessary to improve productivity by building trusting relationships. Perhaps the board needs the legal assurance that it will participate in productivity

[101] See supra Part III.B.1.

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gains. Under TPM's minimalist conception of the board's job, however, the board discharges its duty simply by responding to political pressures in ways that are adequate to keep the team together. There is no reason to expect it to do more.

C. TPM's Distributional Implications

Despite the possible efficiency shortcomings discussed in the previous sections, TPM may still appear attractive to partisans of nonshareholders for distributional reasons. Even if the pies end up being smaller, perhaps the shares to be distributed to workers and other stakeholders could be larger than they are now. TPM appears at least initially to hold great promise in this regard because, by claiming to free the board of directors from the shackles of shareholder primacy, it puts the distributional question at the center of corporate governance. An independent, neutral board would have the power to allocate larger portions of corporate revenues and accord other benefits to workers, even if that meant lower returns for shareholders. On closer inspection, however, the promise proves to be empty. Because TPM does nothing to improve the extralegal status of nonshareholders in relation to shareholders, there is no reason to expect improvements in distributional outcomes. Thus, from a progressive perspective, the element of TPM that seems most appealing ends up being the most disappointing. The remainder of this Essay considers these questions.

1. Distributional Outcomes Under TPM

TPM's political solution to rent allocation leaves nonshareholders to their own devices in extracting the best deal they can get from the board of directors. After the board has divided rents among workers, shareholders, and other participants in amounts minimally sufficient to keep them from quitting the team, any surplus will then be up for grabs. Because workers' interest in maximizing their wages and other benefits conflicts with the shareholders' desire for the highest possible investment return, they must confront each other in the political arena, using whatever muscle they have available to persuade the board to favor their claims. Similarly, if the board must decide whether to take action that will benefit the shareholders but harm nonshareholders (such

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as closing a struggling plant), such decisions also will be determined by the parties' relative ability to exert influence on the board, as will the question of whether workers and other affected nonshareholders receive compensation for their losses.

Under current law, nonshareholder returns depend on contract terms. Likewise, protections such as job security or severance pay must be bargained and paid for, presumably in the form of lower wages. To give workers anything more than they can bargain for would amount to breach of the fiduciary duty owed by the board to the shareholders. This means that the exchange value of the parties' existing endowments (such as capital or the ability to work), supplemented by bargaining power,[102] fully determines distributional outcomes between shareholders and nonshareholders.

From the nonshareholders' point of view, TPM's vision of a political contest with the shareholders replicates the existing market- or contract-based framework for determination of the structure and content of intra-corporate relationships. Both models envision a competitive process in which the board must mediate rival claims to limited resources. As a normative matter, there can be no basis for claiming a right to distributional outcomes other than the results of this contest: "might makes right." As a practical matter, the parties lack the ability to obtain anything more from the board than it is willing to allocate in light of the strength of competing claims. In this regard, whether one conceives of the process as political or contractual does not make any difference. Outcomes should be essentially the same, because TPM's political contest serves the same function, and is likely to yield the same results, as the parties' engagements in the market. It is horse-trading either way, and the same horses are being exchanged. In other words, what is missing from TPM is a conception of the board's role that would make it possible for nonshareholders to do better than this.

Seen in this light, TPM emerges as a sophisticated justification for the current distribution of income among shareholders, workers, and other corporate constituencies. If Blair and Stout are correct that corporate law already reflects TPM's view of the ap-

[102] By bargaining power, I refer in this context to the parties' abilities to obtain for themselves more or less ample shares of whatever gains from trade are on the table. Bargaining power may also play a role in determining how losses are to be allocated among the parties.

propriate relationship among the board and other members of the corporate team, obviously there should be no need to consider legal reform. Corporate law and the distribution of the costs and benefits of corporate activity are fine as they are. Even if TPM is better understood as a normative argument for repeal of the shareholder primacy principle, the model's vision of board decisionmaking as a function of the team members' respective political power implicitly legitimates distributional outcomes likely to be no better than those that exist today.

At this point one might ask whether it is fair to fault Blair and Stout for failing to embrace a progressive, redistributive agenda that they presumably do not support. The criticism seems justified for two reasons. First, the authors themselves suggest that TPM "resonates" with the work of progressive corporate law scholars.[103] Although Blair and Stout are careful to point out TPM's different policy implications,[104] readers struck by TPM's rejection of shareholder primacy may overlook this qualification. A proper understanding of TPM's distributional implications should leave no one in doubt on this score. The recent progressive (or communitarian) critique of corporate law, although a large and diverse body of work, shares common ground in its opposition to a strictly contract-based approach to the definition of nonshareholder rights.[105] TPM's apparent resonance with progressive scholarship in fact is discordant.

Criticism of TPM on the grounds presented here may also be appropriate for a second reason. Regardless of whether TPM reflects the core concerns addressed by progressive corporate law, readers may infer from its rejection of shareholder primacy that

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[103] Blair & Stout, supra note 1, at 286; see also id. at 253 ("[O]ur analysis appears to parallel many of the arguments raised in recent years by the 'communitarian' or 'progressive' school of corporate scholars who believe that corporate law ought to require directors to serve not only the shareholders' interests, but also those of employees, consumers, creditors, and other corporate 'stakeholders.'").

[104] See id. at 254 ("Where progressives have argued that corporate law ought to be reformed to make directors more accountable to stakeholders, the mediating hierarchy approach suggests that directors should not be under direct control of either shareholders or other stakeholders.").

[105] For discussion of this point, see David Millon, Communitarianism in Corporate Law: Foundations and Law Reform Strategies, *in* Progressive Corporate Law, supra note 69, at 1, 4–10.

workers and other nonshareholders would be better off under TPM than they are today.[106] For the reasons stated above, that would be a serious mistake. It now remains to consider more closely whether TPM has any utility for the progressive corporate law project.

2. *TPM and Progressive Corporate Law*

Assuming that TPM is actually a normative theory rather than an explanation for the law as it exists today, what is TPM's relationship to progressive corporate law scholarship? I have already emphasized TPM's endorsement of an essentially contractarian approach to the determination of nonshareholder rights, a stance that I consider to be in sharp conflict with the progressive agenda. Nevertheless, TPM does share common ground with the progressives' rejection of shareholder primacy in favor of broader notions of director responsibility.[107] This section evaluates progressive law reform proposals and then assesses whether TPM can remedy their shortcomings.

Of course, the entire progressive project is objectionable to defenders of the shareholder primacy status quo, but even sympathizers may discern a deficiency in progressive law reform proposals. I refer to the critics' inability to give firm content to their new conceptions of board responsibility. In particular, progressives have yet to devise a sufficiently rigorous analytical framework to structure director decisionmaking in cases in which shareholder and nonshareholder interests conflict. Appeals

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[106] See, e.g., Coates, supra note 79, at 867 ("Because the poor are more often employees and the rich are more often shareholders, it seems reasonable to expect that [the board acting as] a functioning mediating hierarch would distribute a greater slice of the larger pie to the least well-off players on the corporate team.").

[107] See, e.g., Lyman Johnson, Individual and Collective Sovereignty in the Corporate Enterprise, 92 Colum. L. Rev. 2215 (1992); Millon, Redefining Corporate Law, supra note 6; Millon, Theories of the Corporation, supra note 7; Mitchell, Critical Look, supra note 20; Lawrence E. Mitchell, The Fairness Rights of Corporate Bondholders, 65 N.Y.U. L. Rev. 1165 (1990) [hereinafter Mitchell, Fairness Rights]; Mitchell, Theoretical and Practical Framework, supra note 6; O'Connor, supra note 20; Marleen A. O'Connor, Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers, 69 N.C. L. Rev. 1189 (1991) [hereinafter O'Connor, Displaced Workers]. For an insightful caveat from a sympathetic critic, see William W. Bratton, Confronting the Ethical Case Against the Ethical Case for Constituency Rights, 50 Wash. & Lee L. Rev. 1449 (1993).

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to fiduciary responsibility,[108] fairness,[109] or respect for legitimate expectations[110] suffer from a degree of indeterminacy that probably renders them inadequate to the large tasks of reorienting the board's sense of priorities and providing guidance in making tough choices. However supportive one might be of the reform agenda, reliance on excessively general principles may simply leave the board free to fall back on traditional assumptions about responsibility to shareholders.[111]

The task of redefining the board's duty to the corporation's various constituencies in cases of conflict may in fact be intractable. Epistemic limitations and practical exigencies (such as drafting costs) probably make it impossible to provide in advance for the countless contingencies that will emerge in the future. One strength of the traditional fiduciary concept has been its adaptability to unforeseen challenges. However, when the decisionmaker must balance conflicting interests, the fiduciary idea may not be up to the task. It is ill-suited to situations in which a steward must figure out how to serve two masters at the same time. Generality therefore yields discretion that in turn threatens to frustrate the original objective.

I may be overly pessimistic in my reading of the work that has been done so far and there is surely more to be said, but the indeterminacy criticism appears to me to be serious and perhaps fatal.[112] Quite different approaches to the distributional problem may be possible.[113] In the meantime, however, TPM has little to offer to the

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[108] See, e.g., O'Connor, supra note 20; O'Connor, Displaced Workers, supra note 107.

[109] See, e.g., Mitchell, Fairness Rights, supra note 107.

[110] See, e.g., Millon, Redefining Corporate Law, supra note 6.

[111] The permissive approach taken by most of the nonshareholder constituency statutes, see supra note 6, is inadequate for the additional reason that it invites the board to disregard their mandate with impunity.

[112] In contrast, the traditional shareholder primacy norm (as Milton Friedman insisted long ago, see Friedman, supra note 22) at least has the advantage of a single mandate.

[113] Elsewhere, accepting a contractarian approach to the definition of nonshareholder rights, I explore the possibility of changes in default rules as a strategy for improving bargaining results for nonshareholders. Using the example of the choice between employment-at-will and job-security default rules and drawing on behavioral psychology research, I argue that a change to a job-security default could yield benefits for workers despite the neoclassical assumption of invariance. See David Millon,

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progressive effort to redefine the board's responsibility. The model includes no affirmative injunction intended to redirect director attention to nonshareholders; to the contrary, it envisions a board beholden to no one.[114] By itself, removal of shareholder primacy as a legal requirement will not yield benefits for nonshareholders as long as other, extralegal incentives to favor shareholder interests remain effective. Responsiveness to political pressures can serve just as well as—if not better than—legal doctrine to keep directors focused on shareholders. So too can conventions or social norms. Lacking an affirmative duty to nonshareholders (even if vaguely articulated) and also legal (or other) incentives to distribute more to employees than they can obtain through their own efforts, TPM does not even go as far as existing progressive law reform proposals.

Even if TPM were more ambitious than it is and sought board independence from extralegal as well as legal pressures to favor shareholders, it still would be insufficient to improve distributional outcomes for workers and other nonshareholders. Simply put, there is no reason to assume that directors would act more generously even if they believed themselves free to do so. TPM, relying on political pressures, includes no incentives to encourage director regard for nonshareholders. If progressives are serious about a conception of the board's distributional authority that does more than just respond to the parties' leverage, the need remains to devise a new legal regime that defines the board's duty to nonshareholders in terms that are concrete enough to make a difference. These new principles must redress existing bargaining disadvantages in language that is sufficiently determinate to provide meaningful guidance to directors and also to courts called upon to evaluate director decisionmaking. TPM does not purport to address these challenges.

CONCLUSION

Corporate law does not currently reflect TPM's idea of an independent board acting as mediator among the claims and interests of all team members. TPM therefore is better seen as a normative

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Default Rules, Wealth Distribution, and Corporate Law Reform: Employment at Will Versus Job Security, 146 U. Pa. L. Rev. 975 (1998).

[114] See Blair & Stout, supra note 1, at 254.

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project. As such, it presents an impressive argument for rejecting the dominant shareholder primacy understanding of corporate law's purpose, which is reflected in the principal-agent model of the board's relation to the shareholders. TPM's "mediating hierarch" alternative offers the prospect of enhanced efficiency: By vesting authority to monitor performance and allocate production rents among the team members in an independent, legally neutral board of directors, participants can make firm-specific investments confident in the knowledge that they will be protected from the costs of fellow team members' opportunistic rent appropriation. An independent board implies agency costs, but TPM argues that this structural solution is less expensive than rent allocation by means of ex ante specification or ex post negotiation between the parties. More concretely, TPM may be superior to the current legal arrangement, under which shareholders are thought of as owners of corporate assets and therefore enjoy the right to insist that the board privilege their interests over those of nonshareholders.

On closer inspection, TPM raises efficiency concerns of its own. Though free of legal ties to shareholders or any other corporate constituency, the board is nevertheless subject to extralegal, "political" pressures exerted by the various team members. These constraints, not the board's own independent judgment, determine how it will balance the competing claims of shareholders and nonshareholders. One result is a powerful incentive for the team members to engage in rent-seeking, as they compete with each other for the board's favor. TPM may also have negative consequences for firm productivity. Because of its susceptibility to political pressure, the board lacks the incentive to pursue policies designed to discourage mutual distrust and promote cooperation between workers and shareholders, and, given the politicized nature of board decisionmaking, such efforts would likely be met with skepticism in any event. TPM thus may involve inefficiencies that its proponents have failed to appreciate. All team members would bear the costs.

Aside from those efficiency questions, from a progressive perspective, TPM's most troubling aspect is its distributional implications. If the board's rent allocation decisions are to be solely a matter of political power and its existing distribution among workers and shareholders, there is no reason to believe that workers

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would fare any better under TPM than they are able to do now. Shareholders will continue to come out ahead in the rent allocation contest. Despite the apparent appeal of its rejection of shareholder primacy, TPM therefore does little to advance a progressive agenda for corporate law.

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