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The Shareholder As Ulysses: Some Empirical Evidence on Why
Investors in Public Corporations Tolerate Board Governance

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Why do investors in public corporations cede control over corporate assets and outputs to a board of directors, rather than retaining control for themselves? This Article reviews two possible explanations for why shareholders tolerate board control: the monitoring hypothesis, which posits that shareholders rely on boards primarily to control the “agency costs” associated with turning day-to-day control over the firm to self-interested corporate executives; and the mediating hypothesis, which posits that shareholders also seek to “tie their own hands” by ceding control to directors as a means of attracting the extracontractual, firm-specific investments of stakeholder groups such as creditors, executives, and employees. Part I of the Article reviews each hypothesis and concludes that each is theoretically plausible and internally consistent. As a result, the validity of each only can be established, or rejected, on the basis of empirical evidence.

Part II of the Article reviews the available empirical evidence. Many aspects of contemporary corporate law and governance seem, on first inspection, consistent with either the monitoring or the mediating model. In the context of corporate control transactions, however, it is possible to distinguish between legal rules and governance structures consistent with a purely monitoring board, and rules and structures consistent with a mediating board. Part II concludes that, as a positive matter, corporate takeover law is consistent with the view that directors are not just monitors, but also perform a mediating function. Recognizing this, commentators who subscribe only to the monitoring model often argue that the legal rules that govern changes of control are flawed and should be reformed. Part II

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demonstrates, however, that this normative claim is undermined by other empirical evidence, especially new evidence on the charter provisions of firms involved in initial public offerings.

Part III of the Article discusses some future directions for empirical research and identifies some pitfalls to be avoided. It concludes that, while the issue has not been resolved with certainty, at this point the empirical evidence favors the claim that directors do more than simply restraint executive opportunism; they also restrain shareholder opportunism, and so mediate between the firm's shareholders and other important constituencies that make extracontractual specific investments in the firm. What's more, shareholders favor this arrangement. Accordingly, the burden of proof should shift to those who would defend a purely monitoring model of the board.

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INTRODUCTION

Shareholders are often described as the “owners” of corporations.¹ Since at least the days of Adolph Berle and Gardiner Means, however, corporate scholars have understood that in public corporations,

1. See, e.g., *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998) (“the board of directors has the legal responsibility to manage the business of the corporation for the benefits of its shareholder owner”); LEWIS D. SOLOMON, ET AL., *CORPORATIONS: LAW AND POLICY, CASES AND MATERIALS* 350 (4th ed., 1998) (“shareholders are considered to be the corporation's ultimate owners”).

As a number of legal and economics scholars have noted, the metaphor of shareholder ownership is both inaccurate, and misleading. See, e.g., Margaret M. Blair, *Corporate "Ownership"*, BROOKINGS REV. 16 (Winter 1995); Stephen M. Bainbridge, *The Board of Directors as a Nexus of Contracts*, 88 IOWA L. REV. 1, 3 n.5 (2002); Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 409 (2001); Mitu Gulati, William A. Klein & Eric M. Zolt, *Connected Contracts*, 47 UCLA L. REV. 887, 891-93, 896 (2000); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1191 (2002).

shareholder “ownership” does not mean shareholder control.² To the contrary, in the typical large public firm with dispersed stock ownership, control over the corporation's assets and outputs rests in theory and in practice rest not with stockholders, but with the company's board of directors.

This delegation of control poses something of a puzzle for many corporate theorists. The investor who uses her hard-earned money to buy shares from a public firm relinquishes her power to determine how those funds will be used in the future. Her personal assets become corporate assets subject to the directors' control. It is now the directors, and not the investor, who will decide how the firm shall be run, whom it shall hire, and what it shall invest in. It is also now the directors, and not the investor, who will decide whether corporate earnings will be used to pay dividends, or used instead to build empires, raise salaries, and support charities.³

The end result is a system of public corporation governance that has been aptly described as looking more like “director primacy” than “shareholder primacy.”⁴ Which raises the question: why do shareholders

2. See ADOLPH A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) (discussing separation of shareownership from control).

3. See generally Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 299-315 (1999) (discussing this pattern).

In extreme cases, shareholders of a public firm might overcome the hurdles to collective action described by Berle and Means and remove an incumbent board by means of a proxy fight. A board can also lose control of a firm if a hostile bidder appears, surmounts the battery of antitakeover defenses that typically surround a modern company, and ousts the directors. Yet proxy contests and hostile bids both are rare and expensive. As a result, the directors of most public firms as a practical matter enjoy a wide range of latitude to use corporate assets and distribute corporate earnings in a fashion that does not help and may even harm the firm's shareholders. See text accompanying notes 50-56; see generally Stout, *Bad and Not-So-Bad*, *supra* note 1, at 1192-95 (describing how directors enjoy legal discretion to divert firm assets and earnings to nonshareholder groups, and how shareholders' voting rights and rights to sell their shares provide only limited constraints on directors' discretion).

4. The phrase “director primacy” has been used by Stephen Bainbridge to describe corporate law's strong penchant for allocating control over corporate assets and earnings not to shareholders, but to boards of directors. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. (forthcoming 2002) (discussing this pattern).

tolerate this arrangement? On first inspection, one might conclude that shareholders accept director primacy in public firms simply because corporate law requires them to. Section 141(a) of the Delaware corporate code, for example, begins by stating that “[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors”⁵

Yet Section 141(a) also ends with the caveat, “except as may be otherwise provided ... in [the] certificate of incorporation.”⁶ Delaware law accordingly treats board governance as a default rule that can be “bargained around” in the corporate charter. In practice, closely-held companies sometimes do this. Public corporations do not. To the contrary, a board of directors is a near-universal feature of the public firm.⁷

This pattern suggests that, for some reason, participants in public corporations—including investors—*value* director primacy. Just as Ulysses in legend sought to serve his own interests by binding himself to the mast of his ship, investors may be seeking to serve their own interests by binding themselves to boards.

This Article explores the question of how shareholders might benefit from ceding control over their investments to boards of directors. Part I begins by surveying the widely-accepted model of board function that will be referred to herein as the *monitoring* model. The monitoring model of the board posits that shareholders cede control to boards primarily because boards are in a better position than shareholders themselves are to police against the “agency costs” corporate executives otherwise would impose on firms. The monitoring model accordingly views boards of directors as shareholder agents hired to watch over other, less-trustworthy shareholder agents.

The monitoring model is the dominant theory of board control today,

while asserting that directors use their authority to serve shareholders).

5. DEL. CODE ANN. tit. 8, § 141(a) (2002).

6. *Id.* See *infra* text accompanying notes 70-71 (discussing default nature of director governance rules).

7. Indeed, they may be a universal feature. Although alternative governance arrangements are sometimes seen in closely-held firms and LLCs, and are a standard feature of partnerships, I have never seen nor heard of any large public firm opting out of board governance. Even more striking, when public corporations use charter provisions to modify the default rules of director authority, they almost always use them to *strengthen* rather than weaken the board’s power. See *infra* text accompanying notes 71-74.

and it offers many useful insights into the patterns of board structure and behavior we observe. At the same time, however, Part I argues that the monitoring model is seriously incomplete because it fails to explain the fundamental attribute of public firms first highlighted by Berle and Means—extreme separation of shareownership and control. Put differently, the monitoring model explains why shareholders might hire boards of directors to advise them on how to run the firm, and especially to advise them on how and when to hire, compensate, and fire executive employees. The monitoring model does not explain, however, why shareholders would take the additional and radical step of *actually relinquishing control over firm assets and outputs* to a board that is free, as a matter of law, to ignore their wishes.

Part I argues that this separation of shareownership from control can be explained by an alternative, but less widely-accepted, theory of board function described herein as the *mediating* model. The mediating model does not reject the idea that shareholders rely on directors to overcome the coordination problems shareholders themselves face in overseeing the firm's executives. At the same time, however, the mediating model posits that shareholders do not rely on corporate boards *only* to rein in executives. To the contrary, shareholders also rely on boards *to rein in themselves* by weakening shareholder control over firm assets and outputs.

Weakening shareholder control obviously sometimes works against shareholders' ex post interests. According to the mediating model, however, shareholders, like Ulysses, gain greater benefits from tying their own hands in this fashion. Diluting shareholder power—and with it, shareholders' ability to extract wealth from the firm—may ultimately benefit shareholders, by enhancing the firm's ability to attract the firm-specific, sunk-cost investments of other important corporate constituents, including creditors, executives, and rank-and-file employees. The mediating model accordingly does not view the separation of shareownership from control that accompanies board governance as being necessarily a problem. To the contrary, it may be a solution.

Which of these two broad theories of board function—the purely monitoring board model, or the mediating board model—best captures the reality of modern public companies? Part II of the Article begins by observing that the answer cannot be found at the level of theory. Each model of board function is internally consistent and theoretically plausible. To evaluate their merits, we must look to the empirical

evidence.

Part II examines some of that evidence. It begins with the question of which model provides a better description of the way modern corporate governance actually works. In many business contexts the answer to this question is not obvious: it is often possible, when corporate law allows boards to pursue business strategies that sacrifice shareholders' interests to serve those of other constituencies, to nevertheless argue that such strategies serve shareholders' "long-run" interests. "Long run" arguments lose much of their traction, however, in the context of change of control transactions. As a result, the extent to which corporate law follows the mediating model becomes clearly visible.

Commentators who subscribe to the monitoring model of the board accordingly are often forced, in the change of control context, to concede that takeover law is inconsistent with a purely monitoring board, but then argue that this reflects a deficiency of the law rather than a deficiency of the model. Put differently, adherents of the monitoring model argue that the legal rules governing change of control transactions are defective and need reforming.

As Part II observes, however, this latter argument runs afoul of a second important source of empirical information about the normative value of a mediating or monitoring board. Despite the enabling nature of corporate law, public firms avoid shareholder primacy-enhancing "reforms," even at the IPO stage where corporate promoters have the greatest incentive and ability to select governance rules that appeal to outside investors. To the contrary, when firms do modify the default rules of corporate governance they almost always move in the *opposite* direction, selecting charter provisions that strengthen director control over the firm. This pattern strongly suggests that investors, managers, and other corporate stakeholders collectively perceive director primacy as advantageous *ex ante*.

Part III concludes by observing that, while the empirical evidence at present more strongly supports the mediating model of the board than the purely monitoring model, the question has hardly been resolved with certainty. As a result there is much to be gained from further empirical inquiry. Part III points out, however, that many of the empirical studies that have been devised so far to test the monitoring model are unable to distinguish between results consistent with the monitoring model, and results consistent with the mediating model. As a result new tests will have to be devised. In the meantime, it makes little sense to ignore the

clear import of the empirical evidence that is available. Absent contrary empirical evidence, the mediating model should enjoy a presumption of validity.

I. TWO THEORIES OF DIRECTOR CONTROL

Directors, like Rodney Daingerfield, often get no respect. Indeed, in many discussions of corporate governance they are implicitly denied any special role in firm governance at all, and lumped together with the firm's executive officers under the uninformative label of "management."⁸ As a matter of law, however, the rights, privileges, and obligations of corporate directors are quite different from those of corporate executives.⁹ Corporate law--if not all corporate scholars--views boards of directors as serving a unique function in firm governance.

What might that function be? Detailed and explicit analysis of the economic role played by directors in corporations is remarkably rare.¹⁰ Nevertheless, a reader who surveys the contemporary corporate literature quickly will find that many who write in the field seem to share a consensus view of the role directors ought, at least in an ideal world, to play.¹¹ This consensus might be dubbed the *monitoring* model of the

8. See, e.g., ROBERT C. CLARK, CORPORATE LAW 23-24 (1986) (discussing importance of "centralized management" in explaining popularity of corporate form, without distinguishing between officers and directors). One leading text on business organizations does not even grant directors their own entry in its index, instead instructing the reader who hopes to find information on directors to "See Officers and Directors." WILLIAM A. KLEIN & JOHN C. COFFEE, BUSINESS ORGANIZATIONS AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 419 (8th ed. 2002).

9. Compare, DEL. CODE ANN. tit. 8, §141 (2002)(describing rights and duties of directors) with DEL. CODE ANN. tit. 8, §142 (2002) (describing rights and duties of officers).

10. See Lynn L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. CORP. L. 1, 3 (1996) ("Part of the problem with the recent corporate reform debate is that it has given little attention to theories of board ... functioning"). As an example of this inattention, the leading text on the economic functions of corporate law mentions boards on only a few pages, and never explains what function they supposedly perform. See FRANK H. EASTERBROOK AND DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 2-3, 64, 72, 76-79 (1991).

11. For rare examples of explicit discussion of this model, see, e.g., MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS

board.

The Monitoring Theory of the Board

To understand the concerns that underlie the monitoring model of the board, it is useful to start with a thought experiment: imagine a firm with no board. In particular, imagine a large public company in which the decisions normally made under the directors' authority (executive hiring and compensation decisions, dividend declarations, mergers and acquisitions strategy) instead are made by the shareholders themselves. Even a moments' reflection quickly reveals just how unsatisfactory this arrangement would be. The typical public firm has thousands or even hundreds of thousands of shareholders. How can those thousands or hundreds of thousands of individuals reach a collective decision? Shareholder voting is slow, difficult, and expensive, even with modern information technology. In contrast, a board of ten or twelve members can meet and vote relatively quickly, easily, and cheaply. Director voting accordingly enjoys a clear efficiency advantage over shareholder voting as a means of making business decisions on a regular basis.

Director voting offers other important advantages over shareholder voting as well. In the typical public firm, shareownership is widely dispersed, with most investors holding only a relatively small portion of the firm's outstanding shares. As a result, few have the incentive to devote much time to, or acquire significant expertise in, the firm's affairs. Director governance helps to address such problems. By selecting a small group of individuals to specialize in the firm and its affairs, compensating them for this specialization, and providing them with information and access, director governance can permit not only more efficient decisionmaking, but more informed and intelligent decisionmaking as well.

156-170 (1976) (explicitly analyzing functions of boards and concluding that their primary function is to monitor the self-interested actions of professional managerial employees); Stephen M. Bainbridge, *Why A Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 3, 8 (2002) (noting that corporate scholarship has largely ignored the question of why firms have boards and arguing that boards, as groups, are superior to individuals in performing the central task of monitoring the firm's employees); Dallas, *supra* note 10, at 4-10 (explicitly discussing conventional monitoring theories of the board as a control on executive-imposed agency costs).

For these and related reasons,¹² there can be decisive advantages to centralizing corporate decisionmaking in a board of directors, instead of leaving governance in the hands of a large, ever-shifting, and relatively apathetic and uninformed body of public shareholders. Yet it is important to recognize that the coordination problems associated with shareholder decisionmaking cannot, alone, explain why large public corporations have boards of directors. Efficiency demands that someone other than the shareholders take the corporate helm. *It does not, however, demand that “someone” be a board of directors.*

To develop this point, consider some of the alternative solutions that might be devised to address the coordination and rational apathy problems associated with widely-dispersed share ownership. One such solution might be governance by a subset of the firm’s shareholders—say, the ten with the largest holdings. Or, shareholders could simply rely on the firm’s executive officers to make all the decisions. After all, corporate officers are full-time employees who are readily available to the firm and thoroughly familiar with its business. They can make business decisions on the firm’s behalf even more efficiently, and with even better information, than a board or directors can.

If shareholders cared only about informed and efficient decisionmaking, boards accordingly would enjoy an advantage compared to shareholders themselves, but corporate officers would enjoy a distinct advantage over directors. For this reason, shareholders’ coordination problems and the need for more informed and efficient decisionmaking cannot, alone, go very far towards explaining why public corporations universally opt for board governance.

Efficiency and intelligence are not the only qualities shareholders seek in centralized management, however. Shareholders are also

12. Other aspects of board structure may also promote better decisions than would be possible through shareholder voting. For example, because boards meet in person, and because most follow a norm of unanimity, a dissenting director at a board meeting has a much better chance of getting her fellows to listen to and take account of her views than a dissenting shareholder would have in a shareholders’ meeting or a proxy battle. This may allow boards to avoid unwise choices shareholders would approve. Other dynamics of group decisionmaking may similarly make boards superior to shareholders at assessing and evaluating business strategies. *See generally* Bainbridge, *Why A Board?*, *supra* note 11 (arguing that advantages of group decisionmaking help explain use of boards).

concerned about loyalty—about ensuring that, whoever determines the firm’s direction, they steer a course designed to serve the shareholders’ interests. On the question of loyalty, corporate officers suffer from a distinct disadvantage. As employees of the firm they will often face situations where the course of action that is best for themselves is not best for the shareholders. This conflict of interest is obvious and severe on such matters as executive retention and compensation, but it arises in other areas as well.¹³ As a result, shareholders who hire professional managers to run their firms can expect to suffer losses. In the parlance of economics, executive officers are agents, and principals who employ agents incur agency costs.

The two-part analysis offered above—an analysis that relies on directors’ relative ability to make efficient and informed decisions when compared to shareholders, and their relative ability to make impartial and disinterested decisions when compared to the firm’s executive officers—provides the foundation for the monitoring theory of the board. The monitoring model holds that the central economic function of the board is to reduce the agency costs executives otherwise would impose on the firm’s shareholders. Directors are in a relatively good position to perform this function because, compared to executives, they face fewer conflicts of interests, while compared to shareholders, they can more easily observe executive behavior and take responsive action. Thus the monitoring model views directors as agents of shareholders who are employed to watch over other, less faithful agents.¹⁴

Casual empiricism supports many aspects of the monitoring model of board function. As a practical matter, the lion’s share of business decisions in most public firms are made not by directors but by the company’s executives, including the Chief Executive Officer (CEO). Directors, in contrast, play a passive role; boards meet relatively rarely, and often seem content to follow the CEO’s lead except in extraordinary

13. For example, self-interested executives might be tempted to use the firm’s earnings to pursue acquisitions and other strategies that enlarge their “empires,” instead of paying dividends out to shareholders.

14. *See, e.g.,* EASTERBROOK & FISCHER, *supra* note 10, at 76 (describing directors as shareholder agents).

In some limited circumstances, corporate law also seems to call upon directors to act as agents for the broader society, by ensuring that firms obey the law. *See, e.g.,* *Miller v. ATT*, 507 F.2d 759 (3d Cir. 1974) (noting that business judgment rule would not protect directors who knowingly allowed the firm to violate the law).

cases.¹⁵ The monitoring model of the board is consistent with this pattern, for it views the locus of directors' superior decisionmaking ability as confined primarily to areas where executive self-interest conflicts with shareholder interests (for example, on matters of executive hiring and compensation). Outside this limited context, the monitoring model predicts that executives, and not directors, will be the parties who formulate business strategy and run the firm day-to-day. Boards exist primarily for oversight, and intervene only *in extremis*.

Despite its strengths, however, in one vital respect the monitoring model of the board does a remarkably poor job of explaining the governance of public firms. This is because the monitoring model fails to account for the extreme separation of shareownership from firm control that is the hallmark of the public firm. Put differently, the monitoring model explains why shareholders might want to select a small group of independent and expert outsiders whom the shareholders would pay to oversee the firm's professional managers, and to advise the shareholders on management's competence and loyalty. The monitoring model does not explain, however, why shareholders would take the additional and remarkable step of *turning over control over the firm, and all its assets and outputs, to these outsiders*.

To understand this last point it is useful to think about the case of a highly-successful firm that has been retaining its earnings for years. The firm's shareholders believe the corporation cannot earn a superior return on this hoard of cash; they would prefer the money be distributed to them in the form of a large dividend. The monitoring model predicts that shareholders should be able to compel the board to do this. After all, the board is supposedly their "agent," and the shareholders are supposedly the firm's sole residual claimants, entitled to each and every penny the firm earns above the amount needed to pay the fixed contractual claims of employees, creditors, and suppliers.

The default rules of corporate governance do not, however, follow the predictions of the monitoring model. Shareholders cannot pay themselves dividends; if a dividend is declared at all, it must be declared

15. See CLARK, *supra* note 8, at 108 (1986) (observing that it is "unrealistic to view directors as making any significant number of basic business policy decisions. Even with respect to the broadest business policies, it is the officers who generally initiate and shape the decisions. The directors simply approve them, and occasionally offer advice or raise questions").

by the board.¹⁶ If the board refuses to do this, in the typical public firm there is little the shareholders can do about it. Even if the shareholders were to deliver a resolution requesting a dividend to the board, the board would be legally free to ignore it.¹⁷ And any threat to vote the board out of office is likely to sound a bit hollow: proxy contests and hostile takeover bids pose little danger to incumbent directors of public corporations with widely-dispersed shareholders and well-chosen antitakeover defenses.¹⁸

It is difficult to reconcile this fundamental reality of corporate law with the monitoring model's hypothesis that directors are shareholders' "agents." Boards do, of course, have the power to limit how much of the returns from corporate production are allocated to the firm's executives. *But boards also have the power to limit how much of the returns from corporate production are allocated to shareholders.*¹⁹ What's more, shareholders in public corporations seem to happily tolerate this arrangement--even though the enabling nature of corporate law allows them to opt out of it.²⁰

Such observations demonstrate that, in addition to expecting boards to limit executives' abilities to extract wealth from the firm, shareholders also expect--or at least anticipate--that board governance will have the additional effect of reducing *their own* ability to extract wealth from the firm. This second aspect of board governance seems, on first inspection,

16. See DEL. CODE ANN. tit. 8, §170 (2002)(authorizing only directors to declare dividends).

17. See CLARK, *supra* note 8, at 372-373 (discussing how shareholders' voting rights are limited and board is legally free to ignore most resolutions).

18. See *infra* text accompanying notes 51-56, 59-66.

19. The monitoring model accordingly raises, but provides no answer to, the question, "who watches the watchers?" Self-interested directors might, for example, retain corporate earnings in order to expand their own empires, rather than return those earnings to shareholders in the form of dividends. Similarly, they might choose to sooth employee unrest through unnecessary wage concessions, thus purchasing a "quiet life" at the shareholders' expense. As a result it can be argued that if the monitoring model is correct, the board is a dysfunctional institution, because director governance simply adds another layer of agents who are in a position to impose costs on shareholders. *Cf. infra* text accompanying notes 33-39 (explaining why board makes sense under mediating model).

20. For a discussion of alternative governance structures that would allow shareholders to enjoy the monitoring benefits of a board without ceding as much control, see *infra* text accompanying notes 70-71.

to work against shareholders' interests. Closer analysis reveals reason to suspect that shareholders may not only tolerate, but desire, to "tie their own hands" in this fashion.

The Mediating Theory of the Board

To understand how shareholders can benefit from insulating boards from their own command and control, it is important to recognize that executives are not the only actors in the firm who can sometimes exploit other corporate participants. Nor do shareholders always play the role of exploited victim. To the contrary, shareholders are sometimes the exploiters.

This possibility is well-recognized in the corporate literature. Although contemporary scholarship tends to focus, almost obsessively, on the problem of deterring corporate executives from opportunistically imposing "agency costs" on shareholders,²¹ well-developed literatures also detail: how shareholders opportunistically can exploit creditors (e.g., by pursuing very high-risk projects);²² how shareholders opportunistically can exploit other shareholders (e.g., by freezing them out or by threatening to withdraw resources from the firm);²³ and indeed, how shareholders can turn the "agency cost" tables, and opportunistically exploit executives and other corporate employees (e.g., by first leading them to believe their hard work will be rewarded by raises or job security, and then firing them).²⁴ Such shareholder opportunism is

21. See, e.g., sources cited *infra* note 67.

22. See, e.g., Mitu Gulati, et al., *Connected Contracts*, *supra* note 1; Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214 (1999); Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Director's Duty to Creditors*, 46 VAND. L. REV. 1485, 1511 (1993).

23. See, e.g., Margaret M. Blair, *Corporate Law and the Accumulation of Organizational Assets: Lessons from the 19th Century*, UCLA L. REV. (forthcoming 2003); Frank H. Easterbrook and Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986); Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913 (1999); Robert B. Thompson, *Corporate Dissolution and Shareholders' Reasonable Expectations*, 66 WASH. U. L. Q. 193 (1988); .

24. See, e.g., John C. Coffee, Jr., *The Uncertain Case For Takeover Reform; An Essay on Stockholders, Stakeholders, and Bust-Ups*, 1988 WIS. L.

sometimes described in terms of “oppression”, “implicit contracts”, or even “bilateral agency costs.” A number of recent writings, however, including my own and those of Margaret Blair and Lynn LoPucki, describe the problem as one of corporate team production.²⁵

Team production analysis of the public corporation begins with the observation that it takes more than shareholders’ money to make a corporation. After all, a pile of money sitting alone does nothing: to build a productive firm requires other investments as well. Executives must invest skill and creativity; employees must put in time and effort; and local governments may offer tax breaks and specialized infrastructure. Moreover, shareholders are not the only investors in the firm; creditors also often provide funding. Corporate production accordingly is a form of team production involving the inputs of many team members.²⁶ Not just one, but many of these inputs may be essential to the success of the

REV. 435; Charles R. Knoeber, *Golden Parachutes, Shark Repellents, and Hostile Tender Offers*, 76 AM. ECON. REV. 155, 161 (1986); Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 37-42 (Alan J. Auerbach ed., 1988).

25. See, e.g., Blair & Stout, *Team Production*, *supra* note 3; Blair & Stout, *Director Accountability*, *supra* note 1; Lynn M. LoPucki, *A Team Production Theory of Bankruptcy Organization*, VAND. L. REV. (forthcoming 2003); Stout, *Bad and Not-So-Bad*, *supra* note 1; Lynn A. Stout, *Do Antitakeover Defenses Reduce Shareholder Wealth? The Ex Ante/Ex Post Measurement Problem*, 55 STAN. L. REV. 845 (2002); see also ROBERT HAMILTON, CORPORATIONS: CASES AND MATERIALS 26-29 (7th ed., 2001); CHARLES R.T. O’KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 8-9 (3d ed., 1999); Peter Kostant, *Team Production and the Progressive Corporate Law Agenda*, 35 U. C. DAVIS L. REV. 667 (2002); Eric Talley, *Taking the “I” Out of “Team”: Intra-Firm Monitoring and the Content of Fiduciary Duties*, 24 J. CORP. L. 1001 (1999); Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629 (2002); David Millon, *New Game Plan or Business As Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001 (2000). See also Rock & Wachter, *supra* note 23 (discussing problem in terms of “match-specific” investment).

26. See generally Blair & Stout, *Team Production*, *supra* note 3. Although this Article focuses primarily on the corporate contributions of shareholders and executive officers, other groups, such as creditors, rank-and-file employees, and even governments, also can make essential but extracontractual contributions to team production in public firms. See *id.* at 250, 278 (noting this point); see also Stout, *Bad and Not-So-Bad*, *supra* note 1, at 1195-96 (same).

enterprise.

How can shareholders induce nonshareholders to make their essential contributions? One obvious inducement is a formal contract that promises specific rewards in return for specific contributions. For example, a senior executive may work, in part, because she has negotiated an explicit and legally enforceable compensation package that includes wages, deferred compensation, insurance, and other perquisites. Yet economic analysis of the team production problem teaches that in a world of uncertainty and imperfect information, formal contracting can go only so far. This is especially true when team members' contributions become *team specific*, meaning they cannot be easily withdrawn from the team and sold for their full value elsewhere.²⁷ In such cases, it can become impossible to draft formal contracts that protect corporate team members from each other's opportunism.²⁸

To gain a quick sense of how difficult contracting over team production can be, consider the problems involved in drafting a simple contract between two individuals who wish to move a large sofa together. Moving a sofa is a classic example of team production; it takes two to do the job, and each mover's effort is essential. Yet if the movers agree *ex ante* to share their profits according to a fixed formula, each will have incentive to shirk, in the hope of leaving the other to carry more than his share of the load. This is because each mover gets all the benefit from shirking while bearing only part of the cost. Conversely, if the movers agree to wait until after the job is done to split the profits according to who worked hardest, their investment in the job becomes team-specific: neither can recover the value of his effort except by sharing in the team's profits. As a result, each mover now has incentive to "rent-seek" by claiming more than his fair share, because each knows the other is vulnerable, and cannot now withdraw his efforts.

Ex ante formal contracting would be much easier, of course, if the movers could employ a machine that could measure exactly how much effort each expends. Such devices, however, do not exist even for the straightforward task of moving furniture. The *ex ante* contracting problem becomes far more intractable when we are trying to measure the efforts that go into the much more complex task of building a successful

27. See *infra* page 16 (discussing concept of team-specific resources).

28. See generally Blair & Stout, *Team Production*, *supra* note 3, at 265-269 (discussing contracting problems).

business.

Consider the example of a start-up corporate team formed by two individuals, an investor who contributes cash and a professional manager who provides ideas, expertise, and time. As in the case of moving a sofa, each team member's contribution swiftly becomes, at least in part, irrecoverable. After the investor's money has been used to purchase specialized equipment and pay salaries, he cannot recoup the full value of those funds except by waiting to see if the venture is successful. Similarly, after the manager has expended time and effort, or acquired firm-specific human capital (knowledge, skills, and contacts that are uniquely valuable to that firm and cannot be sold elsewhere), she cannot enjoy a return from those sunk-cost investments except by waiting until the venture begins to produce profits.

As this example illustrates, team production often requires team members to contribute assets that, once committed to team production, cannot be withdrawn and sold elsewhere for their full value. In economic parlance, the contributions become *team specific*. Firm-specific human capital is one classic example of a team-specific resource, but the concept of team specific investment is much broader, and also encompasses past investments of time and effort made in the expectation of future rewards. Thus the "team specific investment" and "sunk-cost investments" are used as synonyms below.

Having made specific investments, each team member now finds himself or herself vulnerable to the other's opportunism in ways that formal contracting can do little to eliminate. Suppose, for example, that the manager, eager to ensure a return on her sunk-cost investments of time and skill, demands a contract that entitles her for some period to a salary, a fixed percentage of the venture's profits, and a generous severance package or "golden parachute." The investor will rightly worry that this arrangement creates incentives for the manager to shirk. (The manager gets only part of the returns from working hard, but all of the returns from shirking, not to mention the tempting opportunity to be paid for not working when the parachute is deployed.) Conversely, suppose the investor, to prevent shirking, demands a contract that provides that the manager will be paid in proportion to her efforts and investments, has no golden parachute, and can be fired at any time for cause. The manager will rightly worry that, after she has made her sunk-cost investments, the investor might try to deny her a just share of the resulting profits by claiming she did not use her best efforts, or even try

to fire her for cause.

As an alternative, the parties can try to tie the manager's salary to some "objective" measure of performance, such as share price. Yet in the common situation where performance is not perfectly observable (remember the sofa-movers), a truly accurate and objective performance signal will not exist. As a result, contracts based on signals are not only difficult and expensive to negotiate and draft and inflexible and unresponsive to unanticipated changes in circumstances, but they usually create their own opportunities for rent seeking. Suppose, for example, the firm's share price drops after a competitor enters the market. The investor can claim opportunistically that the loss was due to the manager's bungling, while the manager argues opportunistically that she deserves a raise because only her extraordinary efforts kept the price from dropping more.

Team production analysis accordingly teaches that it is not only possible for corporate executives to opportunistically impose "agency costs" on shareholders—it is also possible for shareholders to opportunistically impose "agency costs" on executives and other nonshareholder groups that make specific investments in the corporate team. To observers accustomed to focusing on the myriad ways in which corporate executives can take advantage of rationally apathetic shareholders, the observation that the exploitation can run in the opposite direction may seem counterintuitive. Nevertheless, this "man bites dog" scenario is not only theoretically possible, but quite plausible in the business world.

To understand why, consider again the example of the start-up venture organized by the investor and the manager. Assume the parties initially agree that if the manager does a good job and things go well, the investor will reward her in the future with job security, raises, and perks in the future. (This sort of understanding is common in many employment relationships.) Five years later, the business is successful, with annual sales of \$110,000. At this point the manager is being paid compensation and benefits that total \$100,000 annually. Assume only 10% of this amount reflects returns on the manager's sunk-cost investments; in other words, the managers could earn \$90,000 if she abandoned her investment in the team and sought employment elsewhere. Finally, assume for simplicity that the managers' compensation and benefits are the firm's only expenses.

Now suppose the investor decides to claim, opportunistically, that

the manager's performance is subpar (a claim the manager would find expensive and difficult to contest in court). At this point, the investor could lower the manager's compensation to \$90,001, and still keep her in the firm. This ten percent reduction in the manager's returns would allow the investor to nearly *double* his annual profits, from \$10,000 to almost \$20,000.²⁹

This example demonstrates how shareholders can face tempting opportunities for "rent-seeking" in any firm where payments to nonshareholders are large relative to net profits (a common business scenario) and even a modest percentage of those expenses reflect extracontractual payments for sunk cost investments (also a common pattern).³⁰ Recognizing this threat, stakeholders might be justifiably reluctant to make specific investments in a public firm where shareholders enjoy unalloyed control. For similar reasons, shareholders might be reluctant to invest in a firm where stakeholders, e.g., executives, held all the power. The end result is that investment may not occur at all, and the firm never comes into being.

Team production analysis consequently casts a spotlight on the often-overlooked problem of how we can induce the various constituencies that comprise the public corporation to make specific investments that cannot be protected by contract or other solutions.³¹ In a

29. Alternatively, the investor might sell the firm to a hostile bidder who intends to replace the manager or to cut her compensation and benefits. Under the numbers assumed, such a bidder would be willing to pay up to a 100% premium for control over the firm. This is a considerably larger premium than actually paid in most hostile acquisitions, see Lucian Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 926 tbl.2 (2002) (finding 37% average premium in hostile deals in recent five-year sample), suggesting that wealth transfers from employees and managers to shareholders could explain all or part of the premiums paid in some hostile takeovers. See generally Stout, *Antitakeover Defenses*, *supra* note 25 (advancing this argument).

30. This example is based on a similar one presented in Shleifer & Summers, *supra* note 24, at 36.

31. Formal contracting is not the only possible solution to this investment problem. In small firms, for example, or those with a controlling shareholder, investors and professional managers may often interact face-to-face, and rely on interpersonal trust and trustworthiness to discourage opportunism. See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1799-1807 (2001) (exploring role of trust in private firms). Market forces, including concern for business reputation, can also police against exploitive behavior among team

series of recent articles written alone and together,³² Margaret Blair and I have explored the idea that boards of directors--in addition to any advantages they offer shareholders in public firms by monitoring executives—may play an essential role in addressing this problem. Space constraints prevent a detailed exploration here. The argument, however, runs roughly as follows.

As discussed above, corporate production often requires a number of groups beside shareholders to make sunk-cost investments in firms that cannot be adequately protected by formal contract or market mechanisms. As a result, a number of groups beside shareholders are potential “residual claimants” or “residual risk bearers” in the firm. These nonshareholder groups recognize that if shareholders enjoyed unencumbered control over the firm, they would not necessarily use that control to maximize joint profits for all team members to share. To the contrary, shareholders might simply extract wealth from other team members by threatening to destroy or expropriate their specific investments. Similarly, if managers or creditors were given complete control, they might rent-seek.

To address this problem of mutual opportunism, corporate team members prefer to cede control over the firm and their sunk-cost team specific investments to an outside party that is not, itself, a residual claimant, and so lacks any direct incentive to try to exploit team members. This outside party is the board of directors. Directors, in their positions as directors, are not entitled to dividends, interest payments, or salaries.³³ By tradition they receive only a flat fee for their services (and

members in some situations, as when venture capitalists act as “repeat players” in the market for start up firms. See D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133 (2000).

32. See Blair & Stout, *Team Production*, *supra* note 3; Blair & Stout, *Director Accountability*, *supra* note 1; Margaret M. Blair & Lynn A. Stout, *Team Production in Business Association: An Introduction*, 24 J. CORP. L. 743 (1999); Stout, *Bad and Not-So-Bad*, *supra* note 1; Stout, *Antitakeover Defenses*, *supra* note 25.

33. Individuals who sit on corporate boards may receive significant dividends, interest payments, or salaries if, in addition to their board positions, they also own a large number of shares, hold substantial corporate debt, or are employed by the firm. In such a case, the director in question may sometimes be tempted to rent-seek by using his or her power as a director to further his or her interest as a shareholder, creditor, or employee. To some extent, the duty of loyalty polices against such behavior, *see infra* note 35. To the extent it does

a relatively modest one at that, although it may not always seem modest to unpaid academics).³⁴ Thus directors—unlike shareholders, creditors, executives or employees—have relatively little opportunity or incentive to use their corporate positions to enrich themselves at other corporate participants' expense.³⁵

Corporate law accordingly gives the board—and not the shareholders or the CEO—ultimate control over the corporation's assets. Similarly, corporate law gives the board discretion to allocate the returns generated by corporate assets among various team members. Shareholders and nonshareholders alike prefer this arrangement. By making the directors the “mediating hierarchs” of the firm, they “tie their own hands,” reducing their own ability to take advantage of each other. The end result is to encourage the sorts of committed investments that cannot be protected fully by formal contract, yet may be essential to business success.

It is important to note that directors can fill this hands-tying role without ever consciously intending to act as mediators among the firm's

not, however, the director's ability to act as a disinterested mediator is reduced. This may explain why, as of the late 1990s, 70% of large firms had boards with a majority of “independent” directors who were not also employees of the firm. John C. Coates IV, *Measuring the Domain of the Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 844-45 (1999). It also raises questions about the wisdom of compensating directors with stock or stock options, a practice that has become common at many companies in recent years. By making directors large shareholders as well, this practice may have the effect of making boards less likely to resist shareholder attempts to opportunistically extract wealth from other corporate constituencies, discouraging those constituencies' extracontractual investments.

34. See CLARK, *supra* note 8, at 108-109.

35. Because of the protection directors enjoy from the business judgment rule in cases that do not involve a direct conflict between the director's personal economic interests and those of the firm, the principal constraint directors are subject to under corporate law is the duty of loyalty, which prevents directors from using their corporate positions to increase their own wealth. See Blair & Stout, *Team Production*, *supra* note 3, at 298-299 (discussing duty of loyalty). Duty of loyalty rules perform an essential function under the mediating model, because they ensure that directors themselves are not residual claimants of the firm. *Id.* A corollary of this view is that governance arrangements that make directors residual claimants—e.g., rules that compensate directors primarily in stock, or rules that allow inside directors to enter interested transactions with the firm when these are approved by “disinterested” directors—who are not truly independent—undermine the mediating role and invite intra-team rent seeking. See *supra* note 33.

various constituencies. Of course, many directors do view themselves as mediators trying to balance shareholders' interests against those of creditors, employees, etc.³⁶ Nevertheless, directors do not have to think of themselves in this fashion to perform a mediating function. Board governance by its very nature makes it more awkward and difficult for *any* of the constituencies of a public company to withdraw resources from the firm. Shareholders who want a dividend, executives who want their options repriced, creditors who want their debt restructured, must all go before the board and make a case requesting such action. This need to offer a justification, alone, can discourage more blatant attempts at rent-seeking. And even a well-reasoned request may be turned down by the board. Thus board governance increases the cost and risk associated with intra-team rent-seeking, discouraging ex post opportunism and encouraging ex ante investment in team production.

The mediating model of the board, like the monitoring model, accordingly views directors as superior corporate decisionmakers not for all the firm's decisions, but for only an important subset of decisions: those that involve a conflict between corporate constituencies that the constituents themselves have been unable to negotiate and have instead opted to kick "upstairs" (at some risk to both sides) for the board's resolution.³⁷ Like the monitoring model, the mediating model leaves day-to-day operations and most business strategizing largely to company executives.

Unlike the monitoring model, however, the mediating model does not confine directors' role only to limiting how much wealth the firms' executives extract from the firm. To the contrary, directors also limit how much wealth is distributed to the firm's shareholders, creditors, and even to the local community. The board not only has the ultimate say in

36. *See, e.g.*, *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (directors may act out of concern for other constituencies, including employees and community); *Credit Lyonnais Bank Nederland, N. V. v. Pathe Communications Corp.*, Civ. A. No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991) (directors may decline to adopt high-risk strategy, in order to protect firm's creditors).

37. As a practical matter, it can be expected that many potential conflicts among corporate team members will never be put before the board for resolution because the team members involved, recognizing that they are acting in the shadow of the board, work out compromises among themselves. For examples, executives faced with unrest among rank-and-file employees may voluntarily increase employee wages while refraining from asking for large bonuses for themselves.

hiring and compensating executives: it also has the ultimate say in whether the firm will pay dividends; whether it will recapitalize in a fashion that helps debtholders; and whether it will pursue or abandon a merger or asset sale that might harm employees and the local community.

The mediating model of the board accordingly differs from the monitoring model in that it does not view directors only as fiduciaries of shareholders. Directors also are fiduciaries of the *firm itself*, an entity that can be conceived as a nexus of firm-specific commitments made by investors, managers, and other corporate constituencies.³⁸ Thus, where the monitoring model casts suspicion on any board decision to use firm assets to provide extracontractual benefits to nonshareholders (e.g., by providing employees with better health care coverage or making donations to local charities), the mediating model takes a benign view of such expenditures. Far from being evidence of malfeasance or "managerial slack", director largesse toward nonshareholders is the natural and anticipated outcome of governance by a mediating board. Similarly, extracontractual payments to managers or employees are not inefficient "agency costs" to be eliminated, but evidence of efficient, surplus-producing team production.

The benefits that director governance provides in terms of encouraging team specific investment are not, of course, costless. It is important to recognize that the mediating model of board governance does not assume or require that directors have a particularly robust incentive to maximize returns on the firm's investments once they have been made. (This lack of incentive can be disturbing to those who favor the monitoring model on the theory that shareholders, whom the monitoring model inaccurately depicts as the firm's sole residual claimants, have such an incentive.) The mediating model simply assumes that directors want to get, and keep, their positions as directors. This means directors have incentive to help bring the public firm into existence, and to encourage corporate constituencies to make specific investments. Having accomplished this, the board also has incentive not to let the firm fall apart. As a result the board will want to ensure that each essential team member receives enough of a return on its investment to induce it to remain in the team instead of seeking outside

38. See Blair & Stout, *Team Production*, *supra* note 3, at 285-86 (discussing firm as nexus of firm specific investments).

opportunities. Beyond this minimum standard, however, the board does not have a particularly strong motive to maximize returns to shareholders, managers, or other residual claimants. Although directors probably want their firms to grow in order to expand their own “empires,” they do not have an especially keen drive to maximize returns on firm assets.

The mediating model accordingly predicts that after firms are created, we can expect boards to run them in a satisficing, but suboptimal, fashion. The result is an “agency cost” borne not just by shareholders but by all the investing members of the corporate team. A mediating board is clearly only a second-best solution to the problem of encouraging sunk-cost investment in corporate production.³⁹

Yet it is important to recognize that the monitoring board also is a second-best solution to the problem of executive-imposed agency costs. A board that serves only the shareholders’ interests would not seek to maximize returns on all the firm’s investments, any more than a mediating board would. Instead, it would seek to maximize only returns to shareholders—sometimes by expropriating wealth from other team members. The result may be to discourage nonshareholders from making extracontractual contributions. Consider, for example, how a firm’s executives, employees, and creditors would likely behave if they believed the firm’s shareholders could, at any time, *require* the board to withhold all extracontractual benefits from these groups, and instead pay out every penny of excess return to the shareholders upon demand. Would they put in the extra hours, extra effort, and extra patience in hard times that make for business success?

Investors who are deciding between investing in a firm governed by a mediating board, and investing in a firm governed by a purely monitoring board, accordingly find their choice boils down to the question: which is more important to business success? The *ex ante* advantage of getting nonshareholder groups to make extracontractual specific investments in the firm in the first place? Or, the *ex post* advantage of optimizing shareholders’ subsequent returns from a firm without those investments? To paraphrase Winston Churchill, the mediating board may be the worst possible form of public corporation governance--except for the alternatives.

39. See Blair & Stout, *Team Production*, *supra* note 3, at 283-84 (discussing mediating board as second-best solution).

III. EMPIRICAL EVIDENCE

As noted in Part I,⁴⁰ most contemporary corporate scholars subscribe to the monitoring model of board function, which confines director decisionmaking primarily to overseeing the firm's executive officers. This model, however, does not do a very good job of explaining the extreme separation of shareownership and firm control we observe in public companies. That separation seems more consistent with the mediating model, which views directors as decisionmakers not only with regard to the distribution of corporate wealth to managers, but also with regard to the distribution of corporate wealth to shareholders, creditors, employees, and other stakeholders.

Despite the intellectual dominance of the monitoring model in contemporary scholarship, both models can claim a long and respectable lineage. The argument that boards ought to act as faithful agents of shareholders can be traced back at least to a 1931 article published by Adolph Berle in the *Harvard Law Review*.⁴¹ Similarly, while the emerging literature on team production offers new and useful insights into how director control can benefit shareholders by promoting other stakeholders' ex ante team specific investments,⁴² variations on the mediating model can be found in the scholarly literature dating back at least the 1980s,⁴³ and the general idea that directors should be free to take account of stakeholders' interests appears much earlier.⁴⁴ Indeed, in

40. *Supra* text accompanying notes 11-16.

41. Adolf A. Berle, *Corporate Powers As Powers In Trust*, 44 HARV. L. REV. 1049 (1931).

42. Team production analysis can help, for example, to shed light on the nature of the firm, *see* Blair & Stout, *Team production*, *supra* note 3, at 271-76 (describing firm as a nexus of firm-specific commitments that are not protected by contract or otherwise), the terms of the "implied contract" entered between and among team members, *id.* at 277-78 (viewing contract as a pact to participate in a process of mutual goal setting and dispute resolution under the ultimate authority of a board), and the rationale for a variety of other-wise puzzling corporate law doctrines, *id.* at 290-315 (describing how team production analysis helps to explain rules of legal personality, fiduciary duty, and shareholder voting).

43. *See, e.g.*, Coffee, *supra* note 24; Knoeber, *supra* note 24; Shleifer & Summers, *supra* note 24; *see also* EISENBERG, *supra* note 11, at 159-62 (discussing board's potential role as "modality" for shareholder and nonshareholder groups to influence managers' decisions).

44. *See, e.g.*, BERLE & MEANS, *supra* note 2, at 312-13 ("It is conceivable,-

the *Harvard Law Review* issue that followed Berle's publication of his shareholder primacy thesis, Professor Merrick Dodd of Harvard argued that directors should seek to advance the interests not only of shareholders, but employees, managers, and the community as well.⁴⁵

As this long tradition of disagreement suggests, one cannot reject either the monitoring board hypothesis or the mediating board hypothesis at the level of theory. Both models are intellectually sound and internally consistent. This may explain why the "Great Debate" (as it was recently characterized by Delaware Chancellors Leo Strine and Jack Jacobs and former Chancellor Bill Allen)⁴⁶ between those who believe directors should serve only shareholders, and those who believe directors should have discretion to serve stakeholder groups as well, has remained unresolved for so long. Nevertheless, while the mediating model enjoys substantial support among those who actually participate in or advise the business community,⁴⁷ the monitoring model is more widely-accepted among academics today. Many if not most contemporary corporate law casebooks and scholarly articles implicitly or explicitly subscribe to notion that the principal job of the board is to protect shareholders by limiting the "agency costs" executives would impose.⁴⁸

-indeed it seems almost essential if the corporate system is to survive,--that control of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream ...").

45. E. Merrick Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1148 (1932).

46. William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067 (2002).

47. For example, as John Coates has observed, academics tend to disapprove of antitakeover defenses as contributing to the problem of agency costs, while businesspeople and regulators support them. See John C. Coates, IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 273 (2002) ("[A]cademics generally have taken a dim view of takeover defenses, and practicing lawyers have generally supported defenses in advising clients, with judges and legislators siding more with practitioners than with academics").

48. See Blair & Stout, *supra* note 3, at 248 n. 1 (citing voluminous literature adopting monitoring model). It should be noted that while the monitoring model is more widely-accepted among academics, there is no shortage of scholars ready to argue that directors should be willing and able to serve a wide range of corporate constituencies. See *id.* at 253 n.16 (citing works that adopt "stakeholder" approach); see also *supra* note 25 (citing sources that discuss team production).

Why does the purely monitoring model dominate over the mediating model in academic circles? The reason seems to lie in a common perception that a mediating board, while possible in theory, is implausible in practice. For example, theorists have argued that firm-specific investment, as practical matter, is not important to corporate production; that nonshareholder groups, as practical matter, can protect their investments adequately through formal contracts; and that the mediating model is unworkable because, as practical matter, directors cannot be expected to do a sufficiently good job of looking out for the interests of nonshareholder constituencies.⁴⁹

These arguments cannot be rejected *a priori*. Nevertheless, their strength ultimately depends on factual assumptions about the nature of the business world. Critiques of the mediating model accordingly can be reduced to empirical claims that, for a variety of reasons, even if a mediating board can add value to a firm in theory it is unlikely to do so in practice. Such claims can be tested. Put differently, the longstanding debate between proponents of the monitoring model of the board and proponents of the mediating model is an empirical argument *that only can be resolved satisfactorily by empirical inquiry—not by armchair speculation*. To choose between the two models one needs evidence.

The discussion below examines some of that evidence. As will be seen, empirical observation strongly suggests that the mediating model of the board provides a better positive description of the way corporate law actually works than the dominant monitoring model does. This strength is especially apparent in the area of change of control transactions.

The Empirical Case for the Mediating Model As A Positive

49. See, e.g., EISENBERG, *supra* note 11, at 162 (concluding on the basis of empirical speculations that “on balance, therefore, the importance of the board’s modality function ... is questionable;” Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 CHI. L. REV. 973, 1022-1026 (2002)(arguing against mediating board on the assumption that directors cannot do a good job of looking after the interests of nonshareholders); Michael Klausner, *Institutional Shareholders, Private Equity, and Anti-Takeover Protection at the IPO Stage*, U. PA. L. REV (forthcoming 2003) (rejecting team production model of antitakeover defenses as promoters of director primacy as a theoretical possibility” that in author’s view “seems unlikely”); Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 Duke L.J. 173, 188-92 (arguing that as an empirical matter, nonshareholders can protect themselves through contracts).

Description of Board Function

In evaluating the relative empirical strength of the monitoring versus the mediating model of the board, it is useful to begin by asking which model does a better job of describing how board governance actually works in modern firms. After all, it is standard practice for economists to judge the value of models primarily by their ability to predict observed phenomena. One of the most significant phenomena observed in public corporations is a dramatic separation between shareownership and control over corporate assets. Any model of the public corporation that fails to predict this fundamental characteristic is deeply flawed.⁵⁰

When this basic criterion—the ability to predict the separation of ownership from control—is applied to the mediating and monitoring models of board function, the mediating model of the board seems on first inspection to be far superior.⁵¹ After all, the monitoring model predicts that directors should act as shareholders’ “agents.” This idea implies both that boards ought to run firms solely in shareholders’ interests, and that when boards fail to do this, shareholders collectively ought to be able to intervene, and make boards dance to their tune. The default rules of corporate law do not fulfill this prediction. To the contrary, provided directors do not use their powers to line their own pockets,⁵² they enjoy legal discretion to run the firm pretty much as they please, including discretion to pursue corporate strategies that benefit nonshareholder group at the shareholders’ expense, over the shareholders’ clear and unanimous objections. Thus directors legally can refuse to pay dividends; can reprice executives’ options; can retroactively increase retirees’ pensions; can shift to expensive but “socially responsible” production methods; and can even donate corporate funds to charity. If a firm’s shareholders pass a unanimous

50. See Bainbridge, *supra* note 4, at 3 (arguing that a primary criterion for evaluating any model of the corporation should be the model’s ability to predict the separation of shareownership from control).

51. See Allen et al., *supra* note 46, at 1079 (“Delaware law inclines toward the entity [mediating board] model. Indeed, it must be acknowledged .. that Delaware law affords the directors room to consider the interests of other constituencies...”); Leo E. Strine, Jr., *The Social Responsibility of Boards of Directors and Stockholders In Charge of Control Transactions: Is There Any “There” There?* 75 S.CAL. L. REV. 1169, 1176 (2002) (noting that outside the context of the *Revlon* case, the mediating model prevails in corporate law).

52. See *supra* note 35 (discussing duty of loyalty)

resolution requesting a board to stop doing such things, the board is free to ignore it.⁵³ If the shareholders bring suit, the directors are protected by the business judgment rule.⁵⁴ And, as Berle and Means famously pointed out, if the shareholders try to vote the directors out of office, they likely will be defeated by their own rational apathy.⁵⁵

The end result is that directors of public firms enjoy, as a legal and a practical matter, an extremely wide range of autonomy to sacrifice shareholders' interests in order to serve other corporate stakeholders. That range is not unlimited, but it is far too broad to be consistent with the monitoring model's prediction that directors are shareholders' "agents."⁵⁶ Given this obvious contradiction, it seems curious that more scholars have not questioned the descriptive validity of the monitoring model.

Two possible explanations come to mind for why the conflict between observed corporate governance patterns, and notion that directors work only for shareholders, often goes unremarked. The first explanation has to do with the fact that, that in many of the situations where boards commonly sacrifice shareholders' returns in order to provide benefits to nonshareholders, such actions can be rationalized, however implausibly, as serving shareholders' "long-run interests."⁵⁷ For example, a decision to retroactively increase retirees' pensions can be

53. Blair & Stout, *Team Production*, *supra* note 3, at 95-96.

54. Blair & Stout, *Team Production*, *supra* note 3, at 121-148.

55. BERLE & MEANS, *supra* note 2, at 80-82.

56. Commentators sometimes suggests that, even if corporate law permits directors to sacrifice shareholders' interests in order to serve those of other constituencies, market pressures, including the pressures of the product market, the capital market, and the market for corporate control, force directors to hew the shareholder primacy line. A moment's thought reveals that this is not necessarily the case for the product market: director concern for consumers is hardly likely to cause a firm to suffer in the product market. Similarly, the observation that directors can favor creditors is not likely to harm a firm's ability to issue debt, which is a far more important source of capital for seasoned firms than equity. And while in theory an active market for corporate control places pressure on directors to favor shareholder interests, in practice hostile takeovers do not pose much of a threat to incumbent boards. *See infra* text accompanying notes 58-67 (discussing limits on market for control).

57. *See, e.g.,* *Paramount v. Time Inc.*, 571 A.2d 1140 (Del. 1989) (Allowing directors of Time to reject hostile offer at a very large premium on the grounds that the shareholders "long-run interests" would be better served by merging Time with another company favored by Time's board).

defended as contributing to higher employee morale that in turn increases productivity, or a decision to donate corporate funds to local charities defended as a purchase of valuable community goodwill. Thus in many cases where boards use their control over corporate assets to provide benefits to nonshareholder groups beyond those required by the firm's formal contracts, it remains possible to dispute, or at least to gloss over, the extent to which this pattern undermines the empirical validity of the monitoring model.

There is a second, and arguably more significant, reason why the discrepancies between the predictions of the monitoring theory and the realities of modern corporate governance are often overlooked. This is the common belief that, even if the law does not require directors to focus on maximizing shareholders' returns, market forces--especially the market for corporate control—may. This belief can be traced back to the development and refinement during the 1970s and 1980s of the hostile tender offer as a vehicle for allowing hostile acquirers to do an “end-run” around the boards of directors of target firms by assembling a controlling block of shares from the target's widely-dispersed shareholders, and then using this newly-created control block to displace the board. The result, many argued, was an active “market for corporate control” which would swiftly punish any board that failed to keep its stock price high, and its shareholders happy.⁵⁸

It is vital to note, however, that hostile tender offers only became common in the 1970s and early 1980s as a result of structural and cultural changes in the investment banking industry that made financing hostile bids feasible. Before these changes, hostile acquisitions were unusual and unlikely.⁵⁹ What's more, it took only a few years for the business world to counter the emerging takeover threat by developing an impressive array of defensive tactics that would-be targets could use to fend off unwanted suitors. By the mid-1980s, for example, it had become common practice for directors of potential targets to shield

58. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Ron J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981).

59. See generally Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHICAGO L. REV. 1037, 1039-1050 (2002) (describing rise of hostile tender offer in the 1970s and the development of the pill and various antitakeover rules in the 1980s in response).

themselves from the threat of a hostile bid by deploying the newly-created antitakeover defense known as the “poison pill.”⁶⁰ Similarly, when hostile bidders began to turn to proxy battles to oust recalcitrant boards, directors at many established firms and a majority of new firms quickly responded by adopting “classified board” provisions.⁶¹

An active market for corporate control accordingly existed, to the extent it existed, during only a fraction of the time the public corporation has been the dominant form of business in the United States. Today incumbent directors of public companies have every opportunity--through poison pills, staggered board provisions, and other defenses, including incorporating in a state with an antitakeover statute--to insulate themselves from all but the most persistent, wealthy, and lucky suitors. Nevertheless, memories of the 1970s and 1980s linger. With them, perhaps, lingers the perception that the dynamic takeover market of the 1970s and early 1980s was somehow “normal”, while the relative security incumbent boards enjoy today is the aberration. From a historical perspective, the reverse is true.

This last observation points to an important irony—it is the change of control context that, in many ways, provides the strongest evidence for the descriptive accuracy of the mediating board model. Consider the example of a hostile acquirer that wants to buy all a target firm’s outstanding shares in a cash merger at a 50% premium over market price. Suppose the target’s shareholders enthusiastically and unanimously support the merger, while the firm’s executive and employees oppose it. Most commentators believe that under Delaware law the board is free to favor the employees’ desires over those of the shareholders by “just saying no” and refusing to sell the firm.⁶² Moreover, it is clear that the board can protect the executives and employees by seeking out a friendly merger with a public firm, even if this means the shareholders receive a lower price.⁶³ Only if the directors make the obvious and avoidable

60. *Id.*

61. See *infra* text accompanying notes 72-74.

62. See Bebchuk et al., *Powerful Antitakeover Force*, *supra* note 29, at 906 (2002); Mark Gordon, *Takeover Defenses Work, Is That Such A Bad Thing?*, 55 STAN. L. REV. 819, 820-22 (2002); Leo E. Strine, Jr., *The Professorial Bear Hug: The ESB Proposal as a Conscious Effort to Make the Delaware Courts Confront the Basic “Just Say No” Question*, 55 STAN. L. REV. 863, 876 (2002).

63. See Stout, *Bad and Not-So-Bad*, *supra* note 1, at 1203-04.

mistake of seeking refuge in the arms of a private company (thus putting the target into so-called “*Revlon* mode”) is a court is likely to intrude on the board’s authority, and possibly oblige it to favor the shareholders by selling the firm to the highest bidder.⁶⁴

Change of control transactions consequently provide some of the best illustrations of the remarkable degree to which corporate law grants directors legal discretion to favor nonshareholder interests at the shareholders’ expense. They also highlight how readily boards can insulate themselves from the supposed pressures of the “market for corporate control.” Finally, change of control transactions draw attention to the weakness of arguments based on shareholders’ “long-run interests.” It is hard to claim, with a straight face, that a particular firm’s shareholders will be better off in the long run if they are denied the chance to sell their shares at a hefty premium, especially when those shareholders eagerly and obviously want to become ex-shareholders.⁶⁵ To advance such an argument, one must claim both that the shareholders are underestimating the value of their holdings by an amount greater than the premium (50% or more in many cases), and that the firm’s directors for some reason cannot possibly persuade the shareholders of their own foolishness.⁶⁶ Arguments for director primacy based on shareholders’ long-run interests accordingly tend, in the takeover context, to lose whatever traction they may enjoy in other situations.

64. See *id.*; *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1985) (holding that when the directors of a public decided to sell to a company with a controlling shareholder, effectively turning a public company into a private one, the board had a duty to maximize shareholder wealth by getting the best possible price for the firm’s shares).

Revlon describes the one context in which Delaware law appears to abandon director primacy for shareholder primacy. Stout, *Bad and Not-So-Bad*, *supra* note 1, at 1203-04. Subsequent cases have drastically diminished *Revlon*’s importance by holding that if directors decide not to sell, or if they pursue a stock-for-stock merger with another public firm, *Revlon* is inapplicable. *Id.*; see, e.g., *Paramount Communications, Inc. v. Time*, 571 A.2d 1140 (Del. 1990). Directors can thus avoid falling into *Revlon* mode when they wish to.

65. This is not to say that allowing boards to reject a premium bid might not serve the long run interests of shareholders *as a class*, nor that such director discretion might not also serve the *ex ante* interests of the shareholders of the particular firm being targeted. Indeed, this is basic idea underlying the mediating model. See *supra* text accompanying notes 30-35.

66. See Bebchuk, *Board Veto*, *supra* note 49, at 997-1007 (making this argument).

Considering how corporate law works in the change of control context accordingly makes it extremely difficult to defend the descriptive accuracy of the monitoring model of board function. A corollary of this observation is that commentators who favor the monitoring model of the board often argue that when it comes to control transactions, the default rules of corporate law are defective, and need to be reformed. Thus corporate theorists who adhere to the monitoring model shift from arguing that the monitoring model is an accurate positive description of how public corporations actually *are* governed, to arguing that the monitoring model provides an attractive normative template for how public corporations *ought* to be governed. The result is vast, and still-growing, literature that critiques the many and varied aspects of corporate law that insulate directors of public firms from an active “market for corporate control.”⁶⁷

This shift from a positive to a normative perspective raises its own empirical difficulties for the monitoring model, however. In particular, the claim that investors would prefer a purely monitoring board to a mediating board is seriously undermined by several recent studies of firm behavior in selecting charter provisions before an initial public offering (IPO).

The Empirical Case for the Mediating Board As a Normative Prescription

As noted earlier, many modern corporate codes treat director governance as a default rule.⁶⁸ Most significantly, Section 141(a) of the Delaware code, while providing for board governance, allows this

67. A large body of literature implicitly adopts the monitoring model and argues that that antitakeover defenses increase agency costs by impeding the market for corporate control. Recent examples include Bebchuk, *Board Veto*, *supra* note 49; Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002); Robert B. Thompson & D. Gordon Smith, *Toward A New Theory of the Shareholder Role: “Sacred Space” in Corporate Takeovers*, 80 TEX. L. REV. 261 (2001). Earlier arguments in this vein can be found in Easterbrook & Fischel, *Proper Role*, *supra* note 58; and Ronald R. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982).

68. *See supra* text accompanying notes 5-7.

pattern to be modified in the certificate of incorporation.⁶⁹ Similarly, Delaware Section 102(b)(1) authorizes incorporators to include in a corporate charter “[a]ny provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders.”⁷⁰

Delaware law accordingly permits incorporators to adopt charter provisions that modify the conventional rules of board governance. For example, a firm could adopt a charter provision that provides for governance by the five largest shareholders. Or, it could permit shareholders to directly elect the CEO, while also electing an advisory board of outsiders to monitor the CEO's performance and make recommendations about when and by whom the CEO should be replaced. (Under this system, the shareholders, rather than turning control of the firm over to the directors, simply pay them for their advice.) Alternatively, shareholders could retain an option on firm control by delegating broad authority to the board but retaining the right to veto board decisions. This approach would grant the board a default right to manage the firm while still requiring the directors to comply with any shareholder resolution approved by holders of a majority of the firm's shares. Less ambitiously, promoters could simply employ charter provisions that preclude boards from adopting poison pills or similar takeover defenses without shareholder approval, thus strengthening the “market for corporate control.”

Any or all of these measures are available to the incorporator who believes investors want greater control over boards. Remarkably, public corporations as a rule do none of these things.⁷¹ To the contrary, when the charters of public firms depart from the default rules of corporate governance at all, they almost always move the *opposite* direction,

69. DEL. CODE ANN. tit. 8, § 141 (2002).

70. DEL. CODE ANN. tit. 8, § 102(b)(1) (2002). For an example of how corporate participants sometimes contract around the default rules of director governance, see *Credit Lyonnais Bank Nederland, N. V. v. Pathe Communications Corp.*, Civ. A. No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991) (describing complex governance agreement at MGM).

71. See, e.g., John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1397 (2001) (observing that charter prohibitions that restrict directors' power to use poison pills “are so rare as to be almost nonexistent for research purposes”).

through modifications that strengthen directors' power *vis a vis* shareholders. This pattern has been observable to some extent since the days of Berle and Means. It has become far more visible in recent years, however, as a result of several newly-published studies of the charter provisions of firms selling shares to outside investors in IPOs.⁷²

IPO studies consistently have found that, in the years following the takeover battles of the 1970s and early 1980s, a substantial and increasing percentage of firms "going public" have chosen to include in their charters provisions that make it more difficult for either the firm's shareholders, or a hostile acquirer, to oust an incumbent board. A common example is a "staggered" board structure that allows only one third of the firm's directors to face reelection in any one year.⁷³ Between the late 1980s and the late 1990s, depending on the time period observed, the incidence of IPO firms whose charters provided for a staggered board rose from around one-third, to over 80%.⁷⁴

Such findings offer at least two important insights into the debate between those who support the monitoring model of the board, and those who favor the idea that boards also serve a mediating function. First, they further undermine the positive version of the monitoring board hypothesis. A recent study has concluded, for example, that since the development of the poison pill, allowing directors the additional protection of a staggered board structure makes it virtually impossible for a hostile bidder to acquire control of a target firm through a proxy contest.⁷⁵ Thus, as more and more public firms adopt a staggered board structure, it becomes increasingly unrealistic to argue that directors of such firms are driven to serve only shareholders' interests out of the fear that, if they do not, they will be disciplined in an active market for corporate control.

More important, the observation that firms going public for the first

72. See, e.g., Coates, *Explaining*, *supra* note 71; Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protections in IPOs*, 17 J.L. ECON. & ORG. 83; Laura Casares Field & Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, 62 J. FIN. 1857, 1861 (2002).

73. This requires a hostile bidder who wants to try to replace incumbent directors via a proxy battle to win at least two elections and to endure a delay of at least one year. See generally Bebchuk et al., *Powerful Force*, *supra* note 67.

74. See Coates, *Explaining*, *supra* note 71, at 1376; Daines & Klausner, *supra* note 72, at 96 tbl. 2; Field & Karpoff, *supra* note 72, at 1861 tbl. II.

75. See Bebchuk et al., *Powerful Force*, *supra* note 67, at 890-91.

time prefer to adopt charter provisions that enhance board authority also poses a direct challenge to any normative claim for the superiority of the monitoring board. To understand why, it is important to recognize that investors considering buying shares in an IPO can readily determine the contents of the firm's charter and the degree to which directors are insulated from shareholder challenge. If investors believe that ceding control to a board is likely to reduce their net future returns, they are free to adjust their willingness to pay for the firm's shares accordingly. As a result, corporate promoters who are planning to take their firms public have every incentive to structure their firms in a fashion that will appeal to outside investors. If they do not, it will be the promoters, and not the investors, who make less money.

The end result is that, when the public corporation is first created—in effect, when the various groups that expect to participate in the firm are negotiating the bargains that will determine their future relationships—the parties that together comprise “the firm” have a unique mutual interest in selecting efficient governance rules that maximize the firm's expected future value. They pick rules that protect director primacy.⁷⁶

76. A similar pattern is suggested by several recent studies of firm behavior in selecting states of incorporation. Corporate law is mostly state law, and a corporate promoter can select which state's laws will apply to her firm by selecting the state in which she files for incorporation. If shareholder primacy rules increase investors' returns (as the monitoring model implies) we would expect to see promoters who plan to sell stock to public investors incorporate their firms in states with rules that favor shareholder control over director primacy. For example, promoters would be attracted to California, which has no antitakeover statute and has not yet validated an important type of poison pill. See Field & Karpoff, *supra* note 72, at 1865 (describing how California law favors takeovers); Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. Pa. L. Rev. 1795, 1854-55 (same). Conversely, they would avoid incorporating in states like Delaware and Nevada, which reinforce director primacy through antitakeover statutes and case law. See Field & Karpoff, *supra* note 72, at 1865 (describing how Delaware law discourages takeovers); Subramanian, *supra*, at 1856-57 (describing how Nevada law discourages takeovers). Instead we observe the opposite pattern. States with relatively strong director primacy rules do better at attracting new firms, and at retaining old ones, than states whose laws seem more “shareholder friendly. See, e.g., Lucian Bebchuk, et al., *Does The Evidence Favor State Competition In Corporate Law*, 90 CAL. L. REV. (2002); Field & Karpoff, *supra* note 72, at 1865 (noting that 23 percent of IPO firms reincorporated in a new state within two years before going public, with the majority reincorporating from states

This empirical reality casts new light on the “monitoring board versus mediating board” debate. IPO studies establish that, at the IPO stage, investors display a “revealed preference” (to employ the rhetoric of economics) for director primacy rules in public corporations. In lay terms, investors *act as if* they value corporate governance rules that place control of the corporation firmly in the boards' hands, more than rules that give more control to shareholders. Neoclassical economic analysis generally presumes that revealed preferences reflect actual preferences. As a result, IPO charter studies support a presumption in favor of the claim that investors in public corporations not only do not object to governance by a mediating board—they desire it.

This claim finds further support in what might be viewed as a recent natural experiment: the rise, and subsequent swift fall, of an active market for corporate control in the 1970s and early 1980s. As noted earlier, it was only after the development of the financed hostile tender offer that directors of public firms became subject to what business scholars soon were enthusiastically describing as the “discipline” of that market.⁷⁷ The business world, however, declined to embrace warmly the prospect of greater board discipline. Within a period of a few years, state legislatures responded by passing a variety of antitakeover statutes; directors responded by deploying poison pills and other defenses; corporate promoters responded by adopting antitakeover charter provisions in new firms; and courts responded by largely approving these developments.⁷⁸

To the observer who subscribes to the monitoring model, the decades between the rise of the large public firm in the 1920s and the appearance of the hostile tender offer in the 1970s—decades during which directors of public corporations were largely insulated from external threats to their incumbency—may seem an unfortunate period during which boards refused to act as shareholders' agents and instead stood by as executives built lavish empires and otherwise imposed “agency costs” on equity investors.⁷⁹ Conversely, the appearance of a lively takeover market in

with relatively unrestricted takeover laws to states with more restrictive laws); Subramanian, *supra*, at 1844 (noting migration towards states with antitakeover provisions, while also noting some migration away from states with especially severe antitakeover laws).

77. See text accompanying note 58, *supra*.

78. See *supra* text accompanying notes 59-67 and 73-74, and n. 76.

79. See, e.g., Henry Hansmann and Reinier Kraakman, *The End of History*

the 1970s and 1980s was a welcome development that improved corporate governance by allowing shareholders to punish directors who failed in their monitoring role. From this perspective, Corporate America's subsequent wagon-circling response in the form of poison pills, classified board provisions, and the like (not to mention judges' and legislators' apparent acceptance of this response) must seem both puzzling and disappointing.

The mediating model offers a different interpretation of these events, however. If director governance does indeed perform an important economic function by tying shareholders' hands in a fashion that encourages other corporate team members' specific investments, it makes sense that the business world would embrace corporate law's default rules of director primacy in the decades prior to the control battles of the 1970s and 1980s. It also makes sense that, when director primacy was threatened by the unexpected advent of the hostile tender offer, corporations responded quickly and effectively with poison pills, staggered boards, and similar devices. It makes sense that corporate regulators smiled benignly on this defensive response. Finally, it makes sense that we now see these director-primacy protecting strategies adopted not only by existing firms, *but also by newly created firms selling shares to public investors for the first time.*

IV. DIRECTIONS FOR FURTHER EMPIRICAL INQUIRY

Empirical observations of corporate governance patterns, and especially studies of IPO charters, strongly suggest that the conventional monitoring model fails to capture the reality of modern public corporation boards. At the positive level, IPO studies demonstrate that directors of newly-public companies enjoy a degree of discretion to sacrifice shareholders' interests that is on its face inconsistent with the monitoring model's premise that directors are shareholders' agents. At the normative level, IPO studies cast doubt on whether shareholders even *want* directors to act as their agents. At the time when they have the greatest leverage to demand optimal corporate governance rules, investors display a remarkably strong and consistent revealed preference

for Corporate Law, 89 GEORGETOWN L. J. 439, 444 (2001)(arguing that unfortunate "manager-oriented" model of governance prevailed from the 1930s through 1960s).

for rules that limit their own power and place control of the firm instead in the hands of a board. This strongly suggests that the monitoring model should lose the privileged status it has enjoyed in recent years.

Yet the observation that IPO studies make it unreasonable to rely unhesitatingly on the monitoring model does not imply that one can, without more, safely assume the validity of the mediating model. Investors' revealed preference for governance rules that favor director primacy create a presumption that investors in fact expect such rules to make them better off. Presumptions can be overcome, however. Thus some theorists have suggested recently that IPO studies do not disprove the monitoring model, because imperfections in the IPO market prevent investors from expressing their real preferences for more shareholder control.⁸⁰ Given the oddities of the IPO market, including persistent underpricing, this argument has some appeal.⁸¹

80. See, e.g., Field & Karpoff, *supra* note 72, at 1858, 1884-85 (briefly discussing theory that promoters somehow can adopt inefficient charter provisions); Lucian Bebchuk, *Asymmetric Information and the Choice of Corporate Governance Arrangements*, available at http://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=327842 (2002) (arguing that asymmetric information in the IPO market may explain why investors who dislike board governance nevertheless cannot "punish" IPO firms that adopt director primacy rules by discounting the price they are willing to pay for shares).

81. Perhaps the best-developed version of this argument can be found in a recent paper by Lucian Bebchuk. See Bebchuk, *Asymmetric*, *supra* note 80. Using the example of charter provisions, Bebchuk argues that firms may adopt inefficient antitakeover defenses that harm shareholders more than they benefit incumbent managers because it is difficult for investors to observe the intrinsic values of firms. Bebchuk hypothesizes that high-value firms offer professional managers the opportunity to extract more in "private benefits" (agency costs) than low-value firms do. As a result, antitakeover provisions are proportionately more valuable to managers of high-value firms. Nevertheless, because investors cannot directly observe firm values, they value all firms at the average. Similarly, when they observe antitakeover provisions, they discount their willingness to pay for shares by the average cost of such provisions. The end result is a cross-subsidy: antitakeover provisions are proportionately less costly to high-value firms than low-value firms. If large enough, this cross-subsidy can make antitakeover provisions cost-effective at large firms. And if high-value firms start adopting antitakeover provisions, low-value firms may too, in order to avoid signaling that they are low-value.

Thus the stage is set for what is likely to be the next round of the “Great Debate”: the search for persuasive evidence that, after taking account of the ex ante effects of director primacy rules in terms of encouraging specific investments, as well as their ex post effects in terms of increasing agency costs, such rules in fact leave investors worse off. Where can we look to find such evidence?

The inquiry is only beginning. Nevertheless, it is essential to recognize from the start that at least two forms of evidence that are commonly offered in support of the monitoring model, in fact *cannot* be relied upon to overcome the implications of IPO studies.

First, the mediating model’s hypothesis that shareholders enjoy a net benefit from director primacy rules cannot be overcome by evidence that, after shareholders have chosen to buy shares in a firm governed by a mediating board, they sometimes complain ex post about having given up control to that board. Shareholders obviously can suffer, after the fact, from director primacy rules that allow boards to favor other constituencies. Yet the mediating model suggests shareholders may receive greater benefits ex ante if those same rules encourage other constituencies to make extracontractual, sunk cost investments in the firm. Antitakeover provisions, for example, can provide equity investors with an extremely valuable ex ante benefit by encouraging professional managers to endure low pay, high risk, long nights, and years of hard work and no vacations. Although it is impossible to draft formal contracts that reliably elicit such contributions, they can be essential to a business’ success, and even its survival.

Nevertheless, after the firm’s managers have made sunk-cost investments in reliance on a firm’s antitakeover defenses, shareholders may be tempted to try to remove the defenses and sell their shares at a premium to a bidder who will bring in a new management team.⁸² Such

Bebchuk's argument is intriguing but rests on strong assumptions. For example, it assumes that investors cannot observe individual firms' values *at all*. Yet if this were true, one would expect the IPO market to implode into a classic “market for lemons” in which high-value firms refuse to participate, because they do not receive full price for their shares, while low-value firms—“lemons”—rush into the market. See generally George Akerlof, *The Market for “Lemons”*: *Qualitative Uncertainty and The Market Mechanism*, 84 Q. J. ECON. 488 (1970).

82. See *supra* text accompanying notes 24, 29-30. Similarly, after shareholders have made their specific investments, professional managers may

attempts at ex post rent-seeking are hardly surprising. They should not, however, be mistaken for evidence that shareholders do not benefit from *and prefer* the mix of corporate governance rules they elected into ex ante.

This analysis reveals the weakness in the arguments of commentators who point to such “ex post” evidence as shareholder proposals to eliminate existing antitakeover defenses (e.g., to redeem poison pills or declassify boards) as evidence that shareholders are harmed by antitakeover provisions.⁸³ Taken alone, the fact that shareholders sometimes protest antitakeover rules in seasoned firms, or even try to remove them, cannot overcome the presumption that investors accept director primacy rules at the IPO stage because they expect a net benefit. After all, Ulysses also complained ex post about his bindings.

A second type of empirical evidence that is sometimes cited in support of the monitoring model, but that cannot be relied upon once one acknowledges the possibility of team production concerns in public corporations, is evidence that director primacy rules allow nonshareholder groups to extract benefits from firms at shareholders’ expense. An example of this kind of empirical argument can be found in a recent study of antitakeover defenses in IPO firms by Laura Field and Jonathan Karpoff.⁸⁴ Field and Karpoff began by noting the inherent tension between the monitoring model’s prediction that antitakeover provisions harm investors, and the empirical observation many firms adopt such provisions at the IPO stage. Reflecting the intellectual dominance of the monitoring model, Field and Karpoff did not discuss--much less attempt to test--the mediating model’s hypothesis that antitakeover protections benefit shareholders at the IPO stage by encouraging nonshareholders’ specific commitments. Instead, they focused primarily on distinguishing between two other possible explanations for why IPO firms adopt antitakeover defenses: (1) market imperfections allow corporate promoters to opportunistically insert, at investors’ expense, provisions that reduce firm value (the agency cost thesis); and (2) antitakeover provisions are a form of executive

be tempted to try to add new and unanticipated takeover defenses to the firm’s charter, in a mirror-image attempt to exploit equity investors by changing the rules in the middle of the game.

83. See, e.g., Bebchuk et al., *Powerful Force*, *supra* note 67, at 891-92 (discussing shareholder proposals).

84. Field & Karpoff, *supra* note 72.

compensation that benefits shareholders by allowing them to pay executives lower salaries (the substitution hypothesis).⁸⁵

Examining a sample of over one thousand firms that went public between 1988 and 1992, Field and Karpoff tested how the presence of an antitakeover defense was correlated with executive compensation. They found that IPO firms with defenses paid their executives more in salary in the year prior to the IPO, than firms without defenses did. From this, they concluded that antitakeover protections do not serve as an efficient substitute for executive compensation, but instead allowed executives to inefficiently impose greater agency costs on a firm's shareholders.⁸⁶

Such findings are susceptible to another interpretation, however. In brief, team production analysis suggests that antitakeover defenses will provide greater ex ante benefits to shareholders in companies where employees' firm-specific investments are more important to business success. Thus, if high salaries reflect the relative importance of human capital investment relative to financial capital investment, it makes sense to see more antitakeover provisions at firms where managers also are paid higher salaries.⁸⁷

85. Field & Karpoff, *supra* note 72, at 1858. Field and Karpoff ran a second test to determine whether antitakeover provisions increased shareholders' ex post returns by giving boards bargaining power to demand higher premia from would-be acquirer. They found the evidence did not support this theory. *See id.*; *see also supra* text accompanying notes 62-66 (discussing and rejecting argument that antitakeover defenses are consistent with monitoring model because directors use them to prevent shareholders from selling at too low a price).

86. Field & Karpoff, *supra* note 72, at 1869-71. Field and Karpoff also found that antitakeover provisions are negatively correlated with the age of the firm's CEO and with the percentage of stock retained by the firm's officers and directors after the offering is complete. *Id.* They concluded that this finding also supported the agency cost thesis, on the theory that a young CEO is more eager to protect her ability to opportunistically extract "private benefits" than an older CEO would be, and that managers also are more likely to impose value-reducing antitakeover defenses on a firm if they own relatively few shares. *See infra* note 87 (discussing how these findings also support mediating theory).

87. It also makes sense that antitakeover defenses are negatively correlated with CEO age (a younger CEO who hopes to be around for some time has more to lose from ex post shareholder opportunism), and that antitakeover provisions are negatively correlated with executive stock ownership (executives who retain enough stock to control the firm do not need antitakeover provisions to protect their specific investments; their voting rights do this for them). *See supra* note 87 (noting these findings)

As this example illustrates, almost any variable one might use as a proxy for the inefficient “agency costs” managers supposedly extract from unwilling shareholders under the monitoring model, is also likely to serve as a proxy for the efficient and legitimate benefits managers receive from mediating boards (with shareholders’ ex ante blessing) under the mediating model. Put differently, the mediating model of the board suggests that when managers receive a greater share of corporate rents—whether in the form of high salaries, job security, or use of a corporate jet—this is not prima facie evidence of inefficiency any more than greater dividends paid to shareholders are evidence of inefficiency. Rather, both types of payments reflect effective team production under a mediating board.

Studies that find a correlation between director primacy rules and returns to nonshareholders accordingly provide just as much empirical support for the mediating model, as they do for the monitoring model. For these and related reasons, it seems unlikely that these kinds of correlations can provide insight into whether IPO firms that adopt antitakeover provisions are harming, or helping, their shareholders in the process.⁸⁸

How then might one go about investigating whether antitakeover defenses and other director primacy rules adopted at the IPO stage in fact inefficiently harm investors, as supporters of the monitoring model claim? A second element of the Field and Karpoff study suggests a

88. For a different problems that can occur in such studies, see Daines & Klausner, *supra* note 72. In this study, the authors attempted to test whether antitakeover defenses were adopted to protect executives’ “private benefits” (a phrase that incorporates the possibility that executives rely on mediating boards to provide them with an extracontractual share of the firm’s surplus, as predicted by the mediating model). Daines and Klausner assumed that the magnitude of private benefits increased when the firm’s founder was still CEO at the IPO stage. They found a negative correlation between the presence of antitakeover defenses and a founder CEO, and concluded that a desire to protect executive private benefits could not explain the use of defenses. However, founder CEOs are likely to be older than non-founder CEOs. See Field & Karpoff, *supra* note 72, at 1859 (noting that the average age of firms “going public” is 18 years, implying that founder who are still CEOs at the IPO stage have been at the helm for nearly two decades). Thus founder CEOs may in fact have less to lose from a takeover, than a younger CEO brought in to replace the founder would have to lose. Daines’ and Klausner’s results accordingly can be read to support the mediating board hypothesis that IPO firms use takeover defenses to efficiently protect the interests of executives who make specific investments that cannot be protected by formal contracts.

strategy that deserves further investigation. This strategy would not rely on shareholders' ex post (and possibly opportunistic) behavior as a means of gauging efficiency. Nor would it look for correlations between antitakeover defenses and nonshareholder benefits, then assume that anything that benefits nonshareholders must come at the shareholders' greater expense. Instead, it would examine how antitakeover defenses affect firm value directly, by examining how the adoption of such defenses at the IPO stage influences *subsequent firm performance*.

Consider how, under ideal circumstances, such a study might be structured. First, one would pull together a sample of firms about to go public that had elected to include antitakeover defenses in their charters. (The promoters of these firms presumably believe that antitakeover defenses increase net firm value.) Then, one would divide the sample into two subgroups: one subgroup would be instructed to eliminate antitakeover provisions from their charters, while the second, control group would be permitted to retain them. Then, one would make a longitudinal study of the operating and stock-price performance of each group over some significant period of time (say, ten years). If the firms that were allowed to keep their antitakeover provisions performed better on average, one could conclude that director primacy does indeed increase firm value. Conversely, if these firms did worse, one could conclude, in accord with the monitoring model, that antitakeover defenses are inefficient.

As a practical matter, of course, such a study is impossible. Researchers cannot dictate to corporate promoters what they may or may not put in their charters.⁸⁹ Nevertheless, Field and Karpoff attempted the next best thing, by examining how the presence of antitakeover defenses at the IPO stage is related to the subsequent operating performance of those firms in the five years following the IPO.⁹⁰

Their results offer an important challenge to the monitoring model. As Field and Karpoff observed, the agency cost explanation for

89. As an alternative, experimenters might try to offer some valuable inducement in order to change promoters' behavior. This approach raises other difficulties, however: even if the experimenter could convince a foundation to fund a grant large enough to bribe a test group of firms into changing their charters, there would remain problems of self-selection, as well as how to control for the wealth advantages firms that accepted the bribes enjoy.

90. Field & Karpoff, *supra* note 72, at 1881-83. Operating performance was measured by the firm's operating return on assets compared to a control firm with similar characteristics but no defenses.

antitakeover defenses, which relies on the monitoring model, implies that takeover defenses that insulate the firm's executives and directors from the market for corporate control should weaken subsequent overall firm performance by encouraging inefficient shirking and stealing.⁹¹ The agency cost explanation accordingly predicts that IPO firms with antitakeover defenses should experience poor subsequent operating results compared to similar firms without defenses.⁹²

Field and Karpoff, however, observed the *opposite* result: the post-IPO performance of firms with takeover defenses tended to *better* than the performance of firms without defenses, especially in the first three years following the initial public offering.⁹³ As Field and Karpoff duly noted, this result was “inconsistent with the notion that takeover defenses at the time of the IPO contribute to poor operating performance.”⁹⁴ It is consistent, however, with the mediating model.⁹⁵

The mediating model posits that, by adopting antitakeover provisions, IPO firms offer may offer additional assurance to executives, employees, and other stakeholders that they can make sunk-cost commitments in relative safety. If this promise of security promotes

91. *Id.* at 1857.

92. *Id.* at 1881. Implicit in this prediction is the assumption that antitakeover defenses cannot provide offsetting benefits (e.g., by encouraging nonshareholders' specific investments) that improve subsequent firm performance

93. *Id.* at 1881-83.

94. *Id.* at 1883.

95. Such results are especially striking because attempts to measure how antitakeover defenses *enhance* firm value are likely to be plagued by false negatives due to selection bias. In other words, antitakeover provisions likely increase the value of some firms more than others (e.g., those most in need of stakeholders' extracontractual specific investments), and individual firms should adopt the governance structures—e.g., classified board or unclassified board—optimal for that firm. A corollary is that we may not see any subsequent performance difference between firms with and without antitakeover defenses, because that firms decline to adopt such defenses should not suffer any relative disadvantage. Field's and Karpoff's finding that IPO-stage defenses are associated with better operating performance accordingly provides even stronger evidence in support of the mediating model than appears on first inspection. It also suggests that, for some reason, firms that could benefit from the adoption of antitakeover defenses are not doing so. For a potential explanation, see Coates, *Explaining Variation*, *supra* note 71 (arguing that the adoption of antitakeover defenses is determined, in part, by whether an IPO firm is advised by a “high-quality” law firm with experience in the area).

specific investment in the firm, the result may be to improve the firm's subsequent operating results, especially in the early years just after the IPO when the uncertainty surrounding any new venture makes it especially difficult to protect specific investments through formal contract. Thus shareholders get exactly what they hope and expect to get from "tying their own hands" by submitting to board governance--a flourishing public corporation.⁹⁶

This is not to suggest that Field and Karpoff's test of operating results provides definitive proof of the superiority of the mediating model. Correlation is not causation, and there are competing explanations for why IPO antitakeover defenses might be associated with superior operating performance in a firm's early years.⁹⁷ Nevertheless, while further empirical study of the effects of director primacy rules on firm value can be expected to run into such difficulties and uncertainties, the point is that further empirical work can, and should, be done. Until it is, corporate scholars cannot safely rely on even the normative version of the monitoring model of the board.

CONCLUSION

Contemporary corporate theorists face a quandary. For the past two decades, much of the scholarly literature on corporate governance has relied, explicitly or implicitly, on the monitoring model of the corporate board. The temptation to do this is understandable. The monitoring model offers an appealingly simple story about the nature of the firm (shareholders are the "principals" and directors are their "agents"). This

96. Similar support for the mediating model can be found in a recent study of firms that announced plans to create a second class of stock with limited voting rights. Such dual-class firms represent an extreme form of public shareholder disenfranchisement. Nevertheless, the study found that firms that adopted dual-class structures enjoyed abnormally positive stock market and operating returns in the four years following the announcement. See Valentin J. Dimitrov & Prem Jain, *Dual Class Recapitalization and Managerial Commitment: Long-Run Stock Market and Operating Performance* (Dec. 11, 2001), available at <http://papers.ssrn.com/abstract=297792> (last visited Oct. 16, 2002); see generally Stout, *Takeover Defenses*, *supra* note 25, at 855 (discussing this result).

97. In an informal discussion, John Coates has suggested an alternative explanation for Field's and Karpoff's results: high-quality law firms tend to advise their clients to use antitakeover provisions for reasons unrelated to efficiency, and better-performing firms tend to hire high quality law firms.

simple story can be explained easily to both laypeople and law students, including the students who manage most law reviews. Moreover, the monitoring model implies that one can measure “good” corporate governance according to the easily-observed variable of share price. As a result, it allows researchers to argue that empirical studies of how changes in corporate law influence share price provide persuasive evidence of what is good or bad for the corporate sector as a whole.

Nevertheless, several recent developments indicate that it no longer wise, if it ever was, to assume that the monitoring model captures either the positive reality of how corporate boards work, or the normative desideratum of how they ought to work. First, theoretical work in economics on the problem of contracting for specific investment in team production has breathed new intellectual life into the competing view of directors’ roles as mediating hierarchs, rather than as shareholders’ agents. Second, widespread use of the poison pill, especially when combined with corporations’ increasing penchant for classified board structures, has highlighted how shareholders do indeed cede control over public firms to boards of directors, as predicted by the mediating model. Third, empirical inquiries into contemporary corporate governance patterns--especially recent studies of IPO charters—provide strong evidence that shareholders in public firm not only cede control to boards, but *want* to cede control to boards.

Investors’ revealed preference for director primacy rules at the IPO stage may, possibly, reflect imperfections in the IPO market rather than investors’ true preferences. Yet the theoretical possibility that investors’ revealed preferences *might not* reflect their true preferences does not establish that investors’ revealed preferences *do not* reflect their true preferences. Before dismissing the remarkably strong and consistent results of IPO studies as irrelevant to the mediating versus monitoring board debate, it seems reasonable to demand some empirical counterweight, in the form of evidence that investors--despite their apparent ex ante enthusiasm for director primacy rules--in fact suffer from them over the life of the firm.

That counterweight remains missing. Meanwhile, casual observations of the empirical landscape--including the observations that (1) the default rules of corporate law favor director primacy; (2) public firms almost never opt out of these default rules; (3) to the contrary, public firms increasingly add charter provisions that reinforce directors’ authority; (4) this occurs not only in seasoned firms but also in IPO

firms; and (5) initial tests suggest that IPO antitakeover defenses, far from harming firm performance, may actually improve it--all suggest that, at least for now, the mediating model enjoys the empirical high ground.

The realities of modern corporate life accordingly strongly recommend that the monitoring model of the board lose the privileged status it has enjoyed during the past two decades, at least among academics. The "monitoring versus mediating board" debate has not, of course, been resolved. Nevertheless, it is time to move the debate away from assertion and armchair speculation, and toward empirical work that can allow us to test each model's validity. In the interim, the burden of proof should be shifted to those who would defend the monitoring model.