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## **CORPORATE LAW AND RESIDUAL CLAIMANTS**

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partial draft  
(do not quote without permission)

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## Corporate Law and Residual Claimants

Bernard Black\*

### Abstract

Common shareholders are not the only important residual claimants on a firm's income. Instead, other claimants, including employees, creditors, preferred shareholders, option holders, suppliers, customers, and the government (as tax collector) also often gain substantially when the firm does well, and suffer when the firm does badly. The conventional contractarian explanation for why only common shareholders vote -- that they are the firm's principal residual claimants -- thus fails to fit the facts.

I propose a reframing of the question -- why do only common shareholder vote -- as several related questions. In a world where common shareholders, employees, creditors, preferred shareholders, and others are all important residual claimants, why do common shareholders receive *voting* control rights, some creditors receive *default-based* and *nonpayment-based* control rights, other creditors receive only *nonpayment-based* control rights, preferred shareholders receive *weak, situation-limited* voting rights, and employees, suppliers, customers, and the government receive *no* formal control rights (unless they happen to also own common shares)?

In answering these interrelated questions, the emphasis shifts from explaining why residual claimants receive control rights to explaining why they often do not. Why are residual interests so much more widely distributed than formal control rights? Why do employees, suppliers, customers, and the government receive no formal control rights even though they are often major residual claimants? Why do preferred shareholders receive voting rights that are almost uselessly weak? Why do trade creditors receive only nonpayment rights while banks receive stronger default rights, when standard contractarian theory -- in which formal control flows from residual interest -- would predict the opposite outcome? The article sketches some possible approaches to answering these questions.

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\* Professor of Law, Columbia Law School. Special thanks to Mark Roe for organizing the Employees and Corporate Governance Conference at Columbia Law School that led me to write this article and to Henry Hansmann for extended discussions that deepened my understanding of the problem of employee ownership of firms. I also benefitted from discussion with Jeffrey Gordon, Charles Sabel, and [to come], seminars at Stanford Law School, Georgia State University College of Law, and [to come], and from comments from [to come].

## I. Introduction

This article argues that we need a new, more complex answer to a fundamental question in corporate law: Why do common shareholders (and only common shareholders) control corporate decisions through voting rights? Why not (or why not *also*) creditors, employees, or others with contractual relationships to the corporation?

The old-old answer (pre-1975) to this question was simple: The common shareholders controlled corporate decisions because they "owned" the corporation. But in the 1970s, scholars reconceptualized the corporation as merely a "nexus of contracts." There was no entity to be "owned." Instead, the corporation was a convenient legal fiction that described a web of relationships among multiple parties.<sup>1</sup> This revived the question: Why vest voting control in only *one* set of contracting parties -- the common shareholders?

"Contractarian" scholars had a simple answer: Common stock, and only common stock, represents a residual interest in a corporation's value. Thus, common shareholders, and only common shareholders, have an incentive to make decisions that maximize the corporation's value. Corporate law evolved to put control, exercised through voting rights, in the hands of those best equipped to exercise it -- the common shareholders.<sup>2</sup> Other contracting parties, in contrast, hold mostly fixed

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<sup>1</sup> The central articles in this reconceptualization were Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 **Am. Econ. Rev.** 777 (1972); and Michael C. Jensen & William H. Meckling, *Agency Costs and the Theory of the Firm*, 3 **J. Fin. Econ.** 305 (1976) (who coined the term "nexus of contracts").

<sup>2</sup> See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 63, 67 (1991) ("[W]hy do shareholders alone have voting rights? . . . The reason is that shareholders are the residual claimants to the firm's income."). The authors had earlier developed their analysis of why only common shareholders vote in a 1983 article. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 **J.L. & Econ.** 395 (1983).

claims. Because their claims are mostly fixed, they have less need for control rights to protect their interests. Moreover, if they held control rights, they would have an incentive to exercise those rights to increase the safety of their fixed claims, rather than to maximize the total expected value of all claims.

The contractarians explained two exceptions to the rule that only common shareholders vote -- preferred shareholders often vote when dividends are in arrears; creditors take control when a company is insolvent -- as consistent with this overall theory. These other contracting parties get voting rights when, and only when, they become residual claimants.<sup>3</sup> The contractarians also explained creditors' limited control rights, conveyed through contractual covenants, as consistent with their theory -- these limited contractual rights protect creditors in the correspondingly limited instances in which their claims are exposed to risk of loss due to actions by the common shareholders.

Thus matters largely still stand today. The contractarian explanation for why only common shareholders vote has developed nuance and qualifications, but it remains widely accepted, at least by scholars who also accept the contractarian conception of the firm. It is the story that we teach to our students.<sup>4</sup> Some contractarian scholars, especially Henry Hansmann, have explored the merits

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<sup>3</sup> See *id.* at 69 ("The right to vote . . . follows the residual claim. When the firm is in distress, the [common] shareholders' claim goes under water, they lose the appropriate incentives to maximize [firm value] on the margin. Other groups, such as preferred stockholders or creditors, then receive [decision rights] until their claims are satisfied.").

<sup>4</sup> See, e.g., **Jesse H. Choper, John C. Coffee, Jr., & Ronald J. Gilson, Cases and Materials on Corporations** 33 (1995) ("[Shareholders] are the 'residual claimants,' who bring to the firm their special ability at risk-bearing . . . . [There is] a persuasive economic rationale for why voting rights should be accorded only (or at least primarily) to the residual claimants. Uniquely, the residual claimants of the firm are interested in the firm's overall profitability, whereas creditors and managers are essentially fixed claimants who wish only to see their claims repaid and who will logically tend to resist risky activities.") (footnote omitted); **Robert C. Clark, Corporate Law** 389-90 (1986) ("[G]iving control to the residual claimants will place the power to monitor the performance of participants in the firm and the power to control shirking, waste, and so forth in the hands of those who have the best incentive to use the power. . . . This viewpoint supports the conclusion that common shareholders should possess voting rights that, at a minimum, give them the power to select or remove the directors and, therefore, the indirect power to control the identity of top management.") (footnote omitted).

of employee (and sometimes customer or supplier) ownership of common stock (and its accompanying voting rights).<sup>5</sup> However, these efforts are commonly viewed as addressing the fringe question of whether employees (or other claimant classes) make good shareholders, not the broader question of why only common shareholders vote, or why employees don't have formal control rights deriving from their status *as employees*, without ownership of common shares.

Other scholars have explored the importance of developing a corporate governance regime that encourages employees to invest in firm-specific human capital,<sup>6</sup> and Margaret Blair has explicitly linked the literature on firm-specific human capital to a claim that employees are important residual claimants by virtue of these human capital investments.<sup>7</sup> However, neither she nor others have pursued very far why this residual interest isn't commonly linked to control.

Contractarians have shrugged off the adoption by some states of "stakeholder" laws that broaden the constituencies whose interests corporate directors should look after.<sup>8</sup> They see these laws as fuzzyminded nonsense, in which stakeholder rhetoric provides political cover for corporate managers who want greater freedom to defend against hostile takeovers.<sup>9</sup> The contractarians have

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<sup>5</sup> **Henry Hansmann, *The Ownership of Enterprise*** (forthcoming 1997); see also **Joseph Blasi, *Employee Ownership: Revolution or Ripoff*** (1988); Jeffrey Gordon, *Employee Stock Ownership as a Transitional Device: The Case of the Airlines*, in **Handbook of Airline Economics** 575 (Darryl Jenkins ed. 1995).

<sup>6</sup> See, e.g., Ronald Gilson & Mark Roe, *Trade-Offs Between Flexibility and Commitment in the Japanese Corporation* (working paper 1996) (describing but criticizing this explanation for lifetime employment in large Japanese firms).

<sup>7</sup> **Margaret M. Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century*** ch. 6 (1995); Margaret M. Blair, *Firm-Specific Human Capital and the Theory of the Firm* (working paper 1996).

<sup>8</sup> See, e.g., Eric Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 **Geo. Wash. L. Rev.** 14, 20-31 (1992) (describing the statutes and developing both their theoretical roots and the antitakeover politics behind their spread).

<sup>9</sup> See, e.g., **Roberta Romano, *The Genius of American Corporate Law*** 57-59 (1993) (contractarian scholar explains stakeholder statutes as antitakeover statutes that were politically supported by, and principally serve the interests of, managers of large corporations); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for*



ignored the leftist academic writing supporting a "stakeholder" view of the corporation, seeing it as misunderstanding the economic nature of the corporation. They have therefore ignored the economic logic behind the leftists' assumption that employees' interests in a firm are only partly captured by their contractual right to wages for work performed.<sup>10</sup>

In this article, I challenge, from within the contractarian paradigm, the factual premises behind the contractarian explanation for why only common shareholders vote. I then sketch a more nuanced and more tentative explanation, based on more realistic premises, for why only common shareholders vote, and why other claimants have the control rights that they have. My proffered explanation, though, is explicitly tentative. A major thesis of this article is that substantial further work needs to be done to understand why the residual interests and control rights that we observe might have evolved as they did.<sup>11</sup>

The contractarian explanation for why only common shareholders vote begins with a factual claim -- that the common shareholders are the principal residual claimants to a firm's value. To assess this claim, we need to define the term "residual interest." I will define a residual interest in a firm to

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*Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 **Stetson L. Rev.** 23, 31-36 (1991) (same).

<sup>10</sup> For a recent collection of (often self-consciously) leftist corporate law scholarship, much of it supporting government intervention to strengthen employees' voice and legal rights, see **Progressive Corporate Law** (Lawrence E. Mitchell ed. 1996). See also *Symposium: Corporate Malaise -- Stakeholder Statutes: Cause or Cure?*, 21 *Stetson L. Rev.* 1 (1991), especially Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 **Stetson L. Rev.** 45 (1991); [others to come].

<sup>11</sup> The principal intellectual precursors for this article include Henry Hansmann's work on employee ownership, cited above in note 5; Andrei Shleifer & Lawrence H. Summers, *Breaches of Trust in Hostile Takeovers*, in **Corporate Takeovers: Causes and Consequences** 33 (Alan Auerbach ed. 1988); discussions with Jeff Gordon about his research project on the transition costs of capitalism (reflected thus far only in his work, cited above in note 5, of employee ownership as a transition device in the airline industry); Chuck Sabel's extended work on alternatives to the traditional hierarchical corporation (some of which is cited in note 28 below), which calls into question standard mechanisms for controlling corporate decisions; and work by a number of scholars (some of it cited below) on understanding bond covenants and creditor remedies.

involve any situation in which *the expected value of a contracting party's future dealings with the firm increases as the firm's value increases, and decreases as the firm's value decreases*. Those expectations can arise both from explicit contract and from the expectations and likelihoods that economists sometimes refer to as "implicit contracts." This definition is appropriate because these future expectations, whether explicit or implicit, are what give their holders incentives to act to increase the firm's value. A *residual claimant* is a person whose relationship to the firm gives rise to a significant residual interest in the firm's success.

If one accepts this definition of residual interest, the contractarian premise that only shareholders are residual claimants is simply false. First, employees are important residual claimants, for multiple reasons, of which firm-specific human capital is only one reason. As a class, they gain when the firm prospers, and lose when it suffers. Moreover, their aggregate gains or losses are often of the same order of magnitude as gains or losses to common shareholders.

From an option perspective, creditors and preferred shareholders are also important residual claimants even for solvent firms, though their aggregate gains when a firm prospers and losses when a firm suffers are often smaller than those of common shareholders and employees. Complex network relationships among industrial suppliers and customers produce interdependence and lead to important residual gains and losses. If General Motors prospers or suffers, so do many of its suppliers and dealers; if McDonalds prospers or suffers, so do its franchisees. Optionholders are obvious residual claimants for those firms that have issued warrants, convertible bonds, or convertible preferred stock. Federal, state, and local governments, as income, sales, and property tax collectors, are large residual claimants -- though of a special nature because their claims are only partly contractual in nature.

The factual premise that only common shareholders exercise formal control over firms is also false. Creditors also exercise important formal control through contractual rights to demand early repayment if the borrower violates debt covenants (which I will call "default rights") and rights to force a nonpaying debtor into bankruptcy (which I will call "nonpayment" rights). From the contractarian perspective, in which company law is primarily just a set of default rules that reduces contracting costs, creditors' default and nonpayment rights and shareholders' voting rights are all contractual control rights, merely of different kinds. And the common shareholders' control rights aren't even always the strongest, in terms of practical power to influence the firm's decisions.

In a world with multiple residual claimants and multiple holders of formal control rights, one could try to develop a modified theory that preserves the logic of the original theory that common shareholders vote because they are residual claimants. In this modified theory, the size of the residual interest belonging to a particular contracting class would predict the strength of that class's control rights: Strong residual interests would get strong control rights; weak residual interests would get weak control rights. But this modified theory also fails. It is simply not true, across the different classes of residual claimants, that stronger residual interests correlate with stronger control rights.

We need instead to reframe the voting rights question -- why do only common shareholder vote -- as several related questions. In a world where common shareholders, employees, creditors, preferred shareholders, suppliers, customers (especially franchisees), the government (as tax collector), and others are often important residual claimants, why do common shareholders receive *voting* control rights, some creditors receive *default-based and nonpayment-based* control rights, other creditors receive only *nonpayment-based* control rights, preferred shareholders receive *weak, situation-limited* voting rights, and suppliers, customers, the government (as tax collector), and

employees receive *no* formal control rights (unless they also own common shares, which they often don't)?

In answering these interrelated questions, the emphasis shifts from explaining why residual claimants receive control rights to explaining why they often do not. Why are residual interests so much more widely distributed than formal control rights? Why do employees receive no formal control rights even though they are major residual claimants? Why do preferred shareholders receive voting rights that are almost uselessly weak? Why do trade creditors receive only nonpayment-based control rights while banks receive stronger default-based rights, when standard contractarian theory -- in which formal control flows from residual interest -- would predict the opposite outcome?

This more complex rephrasing of the voting rights question -- Why do only common shareholders vote? -- will necessarily lead to a more complex answer. I sketch here an answer that seems to me to be consistent with the available evidence, but which needs elaboration and qualification that are beyond the scope of this article. One broad theme in this answer is that the distribution of control rights depends as much on the nature of the residual claimant as on the nature of the residual interest. This becomes especially clear when we ask why the government (as tax collector) is ill-suited to exercise control rights, even though it has a strong residual interest. The government's infirmities in exercising control rights derive from the nature of the government, not the nature of its interest in the firm.<sup>12</sup>

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<sup>12</sup> My emphasis on the nature of the residual claimant can be seen as a broadening of Hansmann's (1997), *supra* note 5, emphasis on what he calls the "costs of ownership" in determining which claimant class owns a firm's common shares and accompanying voting rights. Hansmann argues that the costs of ownership depend heavily on the costs of bargaining within the class of owners. My explanation for the distribution of control rights also relies on the need to economize on bargaining costs, though my concern is often with bargaining costs across claimant classes, while Hansmann focuses on bargaining costs within a claimant class. I also place less stress than Hansmann does on costs arising from heterogeneity within a class of claimants. For example, heterogeneity among the claimant class cannot explain why the federal government (as tax collector) would make a poor holder of formal control rights. My

A second broad factor involves the limited number of different control rights that are available to be distributed. There are only a few distinct flavors of useful formal control rights that have thus far been invented. If giving two claimant classes the same control rights is problematic (I discuss below reasons why this is often the case), firm design must either limit the classes of residual claimants, or else give some residual claimants weak or no formal control rights. The existence of multiple classes of residual claimants suggests that the first option is more costly than the second, in terms of efficiency foregone.

Consider first employees (putting other residual claimants aside). In my view, there are multiple interweaving explanations for why employees usually don't receive formal control rights, even though they have large residual interests. The most important are:

*Limited Transferability:* Employees' residual interests are closely connected with their human capital, and not easily made tradeable. Moreover, efforts to make employees' residual interests tradeable may interfere with the design of explicit and implicit labor "contracts" that give employees incentives to work hard and innovate. Other, more easily tradeable residual interests can migrate to holders who have expertise in monitoring, but employees' interests cannot. This makes employees relatively poor holders of formal control rights, relative to other residual claimants.

*Heterogeneity Within the Class of Employees:* The size of an employee's residual interest depends on her specific job and her specific human capital. Thus, employees' interests are not easily divided into the equally sized units that are needed for voting to be a workable solution to the problem of how to aggregate employee preferences when the firm makes a decision that implicates employee interests. At the same time, there are too many employees, with too many disparate interests, to make attractive a bargaining solution to the problem of how to aggregate employee preferences.

*Problems with Giving the Same Control Rights to Different Claimant Classes:* If employees and common shareholders vote together, with voting power in rough proportion to degree of residual interest, voting outcomes will often not change because shareholders will often be unanimous or nearly so, while employees will often be split.

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explanation of which claimant classes receive control rights also stresses two factors that play little role in Hansmann's analysis of which class should "own" the firm: the transferability of residual interests; and the potential for one claimant class to delegate monitoring responsibility to another class.

*Costs of Multiple Control Rights:* The costs of decisionmaking increase geometrically as control rights are divided among an increasing number of residual claimants. Bargaining simply takes longer and costs more, the more parties there are at the table.

*Delegated Monitoring:* Most of the time, common shareholders will act in ways that are congruent with the employees' interests. This makes it less important for employees to share monitoring duties and accompanying formal control rights with the common shareholders.

*Informal Control Rights:* Employees have important informal control rights that partially substitute for the formal control rights that they lack.

The rule that employees neither vote nor receive contractual control rights thus emerges as an imperfect accommodation to a complex world. If shareholders control firms, the shareholders can sometimes take actions that transfer wealth to themselves from employees. This is unfortunate, but (to offer a medical analogy) this strategic-behavior disease only arises in a minority of the population of firms, while the employee-control-rights vaccine for the disease is costly to administer, will only cure some cases, and has side effects. Thus, the employee-control-rights vaccine is not suitable for general consumption.

This assessment of why employees generally don't have formal control rights admits exceptions where the vaccine is useful. For example, employee ownership of stock (and accompanying control rights) will be more attractive for companies with highly homogeneous workforces, sometimes enough so to outweigh its other costs.<sup>13</sup> Employee ownership may be more attractive for unionized companies under financial stress, where employee ownership can mediate the problem of allocating transition costs and where the costs of bargaining with the union must be incurred in any case.<sup>14</sup>

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<sup>13</sup> See **Hansmann** (1996), *supra* note 5.

<sup>14</sup> See Gordon (1995), *supra* note 5.

Next, how about creditors (putting other residual claimants aside)? There are several complementary explanations for why firms grant different control rights to creditors than to common shareholders. The first reflects the different nature of the residual interests: Granting default-based and nonpayment-based rights to creditors and voting rights to common shareholders, rather than (say) vice-versa, better matches the control rights to the nature of the residual interest. The second reflects a point made above in discussing employees -- if creditors vote together with common shareholders, the common shareholders may simply outvote the creditors.

Additional explanations also reflects points made above for employees. Providing multiple sets of formal control rights magnifies transaction costs. Moreover, common shareholders and creditors often have roughly congruent incentives, which lets the common shareholders serve as delegated monitors on the creditors' behalf. Thus, it can make sense to provide creditors with control rights only in situations where common shareholders' and creditors' incentives diverge most sharply. Hence the use of default-based and nonpayment-based control rights that kick in when the company is in financial trouble -- the situation where the residual, put option component of the creditors' claims is most significant.<sup>15</sup>

Next, why do different classes of creditors get different control rights? Consider a simple firm with two classes of creditors -- a bank that provides senior, secured debt and receives both default-based rights and nonpayment-based rights; and trade creditors, who provide unsecured debt and receive only nonpayment-based rights.<sup>16</sup> If control rights flow from residual interests, this is puzzling:

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<sup>15</sup> In conventional option theory, a debt claim is equivalent, apart from control rights, to a risk-free claim plus the sale of a put option on the company's assets to the company's common shareholders. See **Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance** 490-92 (4th ed. 1991).

<sup>16</sup> In Part IV.C, I consider a more complex firm with three classes of debtholders: senior, mostly secured bank lenders; unsecured, senior subordinated debtholders, and trade creditors.

trade creditors typically suffer much greater percentage losses if a firm fails, yet the bank has stronger control rights.

This pattern is easier to understand if we focus on the costs of conveying default-based control rights to an additional claimant class. Default-based control rights commonly lead to bargaining between a company's managers (negotiating on behalf of the common shareholders) and the holders of the default-based rights. In the vast majority of cases, a debtor which is making timely interest and principal payments negotiates a waiver of the contractual default, and thus avoids bankruptcy. Bargaining between one bank and a homogeneous class of common shareholders is relatively cheap, especially since the shareholders have a ready-made representative in the firm's managers. Banks can specialize in monitoring -- including knowing when and on what terms to waive a contractual default.

In contrast to banks, trade creditors are numerous, which increases bargaining costs. Because their individual claims are typically small, they will rarely find it cost-effective to engage in, let alone specialize in, monitoring. Instead, they protect themselves by providing only short-term credit and monitoring their total exposure to any one customer. The conventional practice of *not* granting default-based rights to trade creditors responds to a combination of the costs of granting control rights to multiple parties, the trade creditors' relative disinterest in exercising default-based rights if granted, and the trade creditors' reliance on a different remedy -- nonpayment-based rights -- that requires less frequent bargaining and less intensive monitoring.

Lastly, how about preferred shareholders (putting employees and creditors aside)? The contractarian explanation -- in which preferred shareholders receive voting rights when they become residual claimants (when preferred dividends are in arrears) fails both because, from an option



perspective, preferred shareholders are residual claimants well before the firm misses a dividend payment, and because preferred shareholders commonly receive voting rights that are so weak as to be almost meaningless -- the right, if dividends are in arrears, to elect a token director or two, who can easily be outvoted. This leads to what Larry Mitchell has called the "puzzling paradox of preferred stock"<sup>17</sup> -- why would anyone buy a security which combines relatively high exposure to loss with weak voting rights; no informal control rights; and only limited comfort from directors' fiduciary duties?

A partial answer to the paradox is that preferred stock is usually issued by highly solvent firms. *Ex post*, a few of them will get into trouble. But *ex ante*, the extra dividends that a firm must promise to compensate preferred shareholders for the lack of meaningful control rights is small, because the likelihood that the firm will get into financial trouble is small. For firms that are in solid financial shape, preferred shareholders, like creditors, can rely on delegated monitoring by the common shareholders. Another part of the answer turns on the costs of multiple sets of control rights: The costs of having another party at the bargaining table when a firm gets into financial trouble apparently outweigh the savings in dividend payments from granting stronger control rights to preferred shareholders.

This answer is a claim, in essence, that it is sufficiently desirable to create a class of residual claimants that lies between the common shareholders and the creditors in payment priority, *and* sufficiently difficult to craft control rights for this class of residual claimants, that firms create these claims without meaningful control rights. Instead of control rights, the preferred shareholders receive

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<sup>17</sup> See Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)*, 51 **Bus. Law.** 443 (1996).

an *ex ante* bribe, through higher promised dividend payments, to compensate for the risk that they will be taken advantage of *ex post*, when a firm runs into financial trouble.

This adaptation fits a broader pattern. As a firm's (mostly) fixed claims decline in priority of payment, from banks to trade creditors to preferred shareholders, the claimants' control rights get weaker, when standard contractarian theory would predict that they should get stronger. An explanation for this pattern must rely heavily on delegated monitoring and on the bargaining costs that result from granting control rights to multiple claimants. Which residual claimants get control rights then turns on the relative usefulness of control rights in reducing the costs of obtaining capital in different forms.

When we look at the multiplicity of a firm's residual claimants, we see many additional instances of such accommodations. Employees, trade creditors, preferred shareholders, minority common shareholders in an insider-controlled firm, holders of nonvoting common stock, suppliers, customers and the government (as tax collector) all have weak control rights that leave them vulnerable to strategic behavior by the holders of stronger control rights in some circumstances. In each case, there are examples, sometimes plentiful, of exploitation of the strategic behavior opportunities thus created. Yet these structures persist.

The multiple instances where we find important residual interests coupled with weak or no formal control rights suggest both that: (i) scattering residual interests widely has important efficiency properties; and (ii) scattering control rights as widely as residual interests is difficult and costly. Only for a select few classes of residual claimants have useful formal control rights been developed. Other classes of claimants make do with control rights that are manifestly inadequate to protect their residual interests. Yet creating multiple types of residual interests apparently remains

valuable enough to justify creating them without accompanying control rights, presumably by offering *ex ante* a higher price or other benefits to residual claimants who forego formal control rights.

This article proceeds as follows. Part II develops my concept of a "residual interest," as well as the standard explanation for why only common shareholders vote and the factual flaws underlying the standard explanation. It then reframes the question as one of understanding why different classes of residual claimants receive different, and sometimes no, formal control rights. The remainder of this article begins the task of suggesting an answer to this reframed question. Part III addresses the most important puzzle: Why do employees generally not receive control rights? Part IV turns to creditors. It explores why different creditors receive different control rights, and especially why the most vulnerable creditors, trade creditors, generally receive only weak, nonpayment-based control rights. Part V considers the control rights of preferred shareholders, especially why this class of residual claimants receives control rights that are so weak as to be almost meaningless.

Part VI pulls the pieces together: An important reason why one class of residual claimants receives weak or no control rights is the high transaction costs from granting control rights to multiple parties. An important design problem in corporate governance, hidden by the contractarian assumption that only common shareholders are residual claimants, is how best to allocate the scarce resource of control rights among multiple classes of residual claimants. Part VII sketches some implications of my analysis -- especially implications for the possibility of employee-governed firms and for the design of employee contractual claims against corporations.

It is important to my project to mention suppliers, customers, optionholders, and the government (as tax collector) as important residual claimants, but beyond its scope to explore the nature of their residual interests or their formal and informal control rights. The analysis below is

limited, for the most part, to employees, creditors, and preferred shareholders. I similarly treat firms where tort claimants hold significant residual interests as beyond the scope of this article. I focus in this article on relatively large firms where at least some shareholders do not work in the business. The allocation of control rights in closely held companies presents some special concerns that are not addressed below.

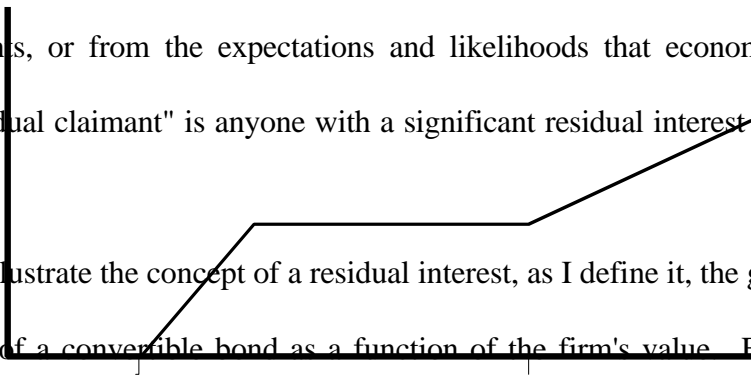
## II. The Standard Explanation and Its Problems

This part develops the standard contractarian argument for why only common shareholders vote and the problems with the standard argument. The claim that a corporation has numerous important residual claimants will seem immediately obvious to some readers, and obviously wrong to others. My intent is to offer a careful defense of this claim designed for the skeptics, at the cost of a discussion that will seem overkill for those who are already inclined to accept the claim.

### A. The Meaning of "Residual Interest"

I define a "residual interest" in a firm to involve any situation in which *the expected value of a contracting party's future dealings with the firm increases as the firm's value increases, and decreases as the firm's value decreases*. These expectations can arise from explicit contract, from statutory entitlements, or from the expectations and likelihoods that economists call "implicit contracts." A "residual claimant" is anyone with a significant residual interest in the firm's future success or failure.

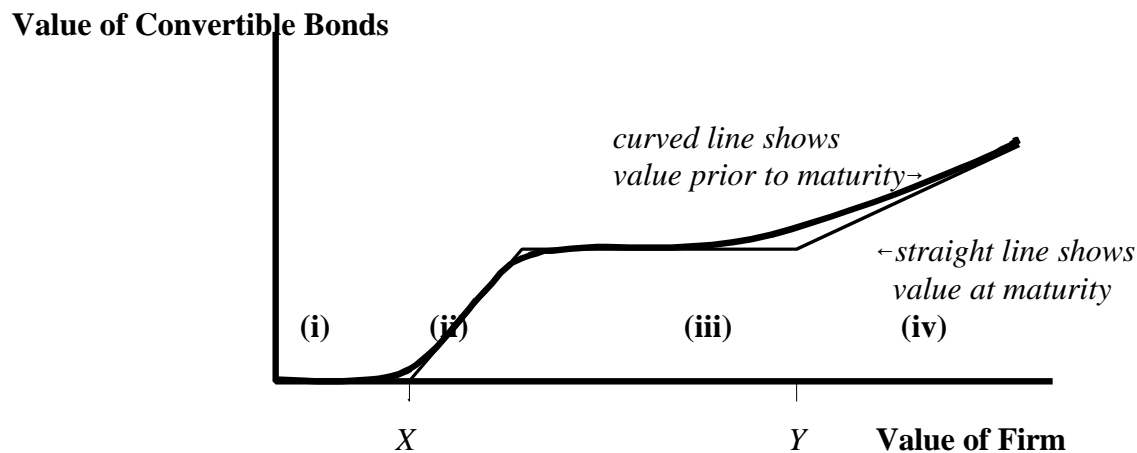
In order to illustrate the concept of a residual interest, as I define it, the graphs below show the expected value of a convertible bond as a function of the firm's value. Figure 1 shows the convertible bond's expected value, on the assumption that the firm will be liquidated tomorrow.





Next, let's relax the assumption that tomorrow the firm will liquidate or the bonds will mature. If we instead assume that the bonds mature some years hence, and the firm is likely to continue in existence until then, the straight lines of Figure 1 will become rounded. This is shown in Figure 2, which also shows the straight line relationship of figure 1 for comparison.

**Figure 2**  
**Value of Convertible Bonds Prior to Maturity**



There are again four regions of interest, but they now blend smoothly into each other. The convertible bonds are equivalent to a combination of:

a risk-free fixed claim;

minus a put option which the bondholders have sold to the firm's common stockholders, exercisable by defaulting on the bonds, with an exercise price equal in present value to X (the inflection point between regions (i) and (ii));

plus a call option on a fraction of the firm's common shares, with an exercise price equal in present value to Y (the inflection point between regions (iii) and (iv)).

There are regions where the value curve rises relatively steeply, indicating that the convertible bondholders have a strong residual interest, and regions where the value curve rises less steeply,

indicating that they have a weaker residual interest, and instead hold primarily a fixed claim. On the whole, the convertible bondholders have a significant residual interest for a wide range of firm values.

For employees, the concept of residual interest is conceptually similar. We can imagine graphing the value of their employment to all current employees as a class, over and above their next best employment opportunity, as a function of firm value. My claim, defended in Section C below, is that this graph has a significant positive slope. That slope, in turn, translates into employees having a significant residual interest in the firm's success. To be sure, the employees' residual interest cannot be neatly graphed, because their interest is in large measure implicit. Moreover, the size of the residual interest depends not only on the firm's value today, but also on the path by which the firm achieved that value, especially recent past increases or decreases in firm value. That complexity cannot be captured in a two-dimensional graph of claim value versus firm value.

My definition of "residual interest," including both explicit and implicit claims, and focusing on a time when liquidation is not immediately in prospect, requires defense. The concept of "residual interest" could be given another meaning, for which the factual claim that the common shareholders are the principal residual claimants is more defensible. When a firm is liquidated, the common shareholders will be paid last, to the extent that formal legal priority is observed and the firm's liquidation value exceeds its explicit obligations to other claimants.

However, a definition of residual interest based on priority of payment when a firm is liquidated is the wrong definition, if the goal is to understand how residual interests relate to control rights. In the normal course, profitable firms are seldom liquidated. *Ex ante*, when a firm must make investment and other decisions, liquidation in the near-to-medium term is a low probability event. It is far more likely that the firm will continue to operate, generating gains and losses to different

claimants relative to their current expectations. Those potential gains or losses provides corresponding incentives to act to increase the firm's value. Moreover, who controls a firm that is about to liquidate is relatively unimportant, because the firm is ceasing operations and has very few decisions left to make. Assigning control rights properly is far more important for a firm that is not about to liquidate, because such a firm has far more value-increasing or decreasing decisions to make.

If the probability of liquidation in the near future were high, then my expected-value definition of "residual claim" would converge -- for a solvent firm -- to the liquidation-value definition. In fact, over a portfolio of firms, the probability of near-term liquidation is low, and the probability of a liquidation which includes full payment of explicit claims with something left over for common shareholders is even lower. Viewed *ex ante*, most of the expected returns to common shareholders and other claimants will come not from payments in liquidation, but instead from payments generated by an ongoing business.

The firm's governance structure should be chosen to maximize value over a full range of possible future outcomes. Since our goal is to explore the link between having a residual interest and having formal control rights, the definition of "residual interest" should reflect a full range of possible outcomes, not just the low-probability outcome of near-term liquidation with full payment of explicit obligations.<sup>18</sup>

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<sup>18</sup> One could, of course, design different governance structures *ex ante*, to handle different situations that may arise *ex post*. Bankruptcy law offers an example. One a firm crosses the threshold of the filing of a bankruptcy petition, special governance rules come into force, to handle the special problems and incentives that arise during a bankruptcy proceeding. A standard bank loan agreement also achieves, to a degree, different governance rules for different situations. A covenant default is rarely a reason for the bank to accelerate its loan, forcing the company into bankruptcy, and far more often an occasion for renegotiation of the terms on which the bank will continue to lend, usually in a way that gives the bank closer control over the company's activities, at a time when the bank's need for that control is relatively strong, and the controls can be tailored to the firm's current circumstances, in a way that was not feasible when the loan was made. The nature of control rights in these kinds of special situations are outside the scope of this article.



### III. Conclusion

If firms had a single class of residual claimants, it would be easy to justify giving formal control rights over the firm's actions to that class. But firms are far more complex than that. Common shareholders, employees, creditors, preferred shareholders, option holders, suppliers, customers, and the government (as tax collector) all gain (lose), often in substantial amounts, when the firm does well (badly). The recognition that firms have multiple residual claimants suggests rephrasing the old question -- Why do only common shareholders vote? -- in broader terms: Which claimants should have formal control rights over the firm's actions, and what kinds of control rights? Why do we observe the common pattern in which common shareholders receive voting control rights, banks receive default-based and nonpayment-based control rights, trade creditors receive only nonpayment-based control rights, preferred shareholders receive weak voting rights when dividends are in arrears, and employees and other claimant groups receive no formal control rights, unless they also own common shares? Why are residual interests so much more widely distributed than formal control rights? In answering these interrelated questions, it is as important to explain why some residual claimants do not received formal control rights as to explain why other claimants do.

This article, despite its length, only opens a window on a broad area of inquiry that corporate scholars have largely neglected. I take the distribution of residual interests to corporate value among multiple classes of claimants as given, and seek to explain why control rights often don't follow residual interests. A closely related inquiry is: Why has the corporate form evolved such a rich variety of residual interests (and what kinds of claims) so widely, despite its inability to design control rights that more than loosely match these residual interests?

The contractarians replaced one black box (the corporation as legal entity) with another, only slightly less opaque box (the corporation as nexus of contracts). We need, as Ronald Coase has long

urged, to open that box and study systematically the contracts it contains.<sup>19</sup> Further progress in opening the nexus-of-contracts box will require a mix of integrative, broad-brush treatment of main themes, of the kind attempted here, and detailed examination of particular claimants, and the nature of their control rights.

This article is positive in nature. I seek to understand the residual interests and control arrangements that we observe in the world, not to prescribe government intervention designed to reshape those arrangements. But, because others are not similarly restrained, it is worth closing with the view that the complexity and variety of residual interests and accompanying formal and informal control rights should make us skeptical about how often government, with the usual blunderbuss tools available to it, can reshape those arrangements to promote more efficient firm operation or a fairer society.

Sometimes, the government can usefully intervene. For example, many of the most prominent corporate law rules involve efforts to shape the control rights enjoyed by common shareholders -- though even here, I have elsewhere expressed skepticism about how often these rules depart significantly from the rules that would be chosen voluntarily in the charter if the law did not intervene.<sup>20</sup> But one can believe that employees are large residual claimants, and that they are vulnerable to strategic behavior by shareholders that transfers wealth from the employees to the shareholders, and still oppose the commonly proposed solutions -- including German-style

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<sup>19</sup> See **Ronald H. Coase, *The Firm, the Market and the Law*** 30-31 (1988).

<sup>20</sup> See Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 **Nw. U.L. Rev.** 542 (1990).

codetermination,<sup>21</sup> using constituency statutes to broaden the fiduciary duties of boards of directors,<sup>22</sup> plant-closing laws,<sup>23</sup> mandatory employee severance payments, enforcing employees' implicit "contracts" with the firm,<sup>24</sup> and restricting at-will termination -- as likely to do more, and sometimes much more, harm than good. The persistently high unemployment rates in the welfare-state economies of Western Europe, likely due in part to labor market rigidities resulting from employee-protective legislation, remind us that no law yet devised can protect employees against perhaps the largest risk they face -- not being hired in the first place.

Similarly, one can believe that franchisees are important residual claimants, and still be skeptical about the value of franchisee-protection laws, such as those preventing at-will termination of the franchise contract. After all, alternatives, including explicit contractual restrictions on the franchisor's right of termination and joint franchisee ownership of the franchisor, were readily available, yet are often not chosen. Just as employee-protection laws can reduce employment opportunities, franchisee-protection laws can deprive potential franchisees of the opportunity to open a franchised business, because potential franchisors either can no longer earn an economic profit, or can earn more by owning, instead of franchising, individual outlets.

When we look across the whole panoply of residual claimants, situations where a class of residual claimants is vulnerable to expropriation of some or all of their residual interests emerge as

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<sup>21</sup> [cites to come - to articles in this conference and others promoting this approach for other countries]

<sup>22</sup> See, e.g., Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 **Cornell L. Rev.** 899 (1993); Stone (1991), *supra* note 10.

<sup>23</sup> See Worker Adjustment and Retraining Notification Act, 29 U.S.C. § 2101-2109 (19\_\_); [cites to related articles to come].

<sup>24</sup> See, e.g., Marleen A. O'Connor, *Promoting Economic Justice in Plant Closings: Exploring the Fiduciary/Contract Law Distinction to Enforce Implicit Employment Agreements*, in **Progressive Corporate Law** 219 (Lawrence Mitchell ed. 1996).

the norm rather than the exception. This suggests that complete solutions to the risk of expropriation are not available, or have expected costs that exceed their expected benefits. The complexity of the partial, contractual responses to the expropriation risk, which this article has only sketched, suggest that opportunities for significant improvements through legislative fiat will be rare.

Moreover, simple political economy predicts that legislation to protect residual claimants will rarely be designed with efficiency as its central goal. The losers from the creative destruction that flows from a market economy will be at the political bargaining table; the winners will often be absent. Thus, even if small opportunities for efficiency gains through legislation exist, we should be skeptical about whether they will be seized, or whether they are even the principal motive behind calls for new laws.

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