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Towards a Bargaining Theory of the Firm

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Introduction

This Article analyzes the relationship between shareholders and managers.[1] Adolf Berle and Gardiner Means share credit for bringing manager-shareholder relationships out of the boardroom and into the "Street." In their 1932 book, *The Modern Corporation and Private Prop-*

[1] This Article assumes that the role of corporate managers should be to maximize the wealth of shareholders. It is not the purpose of this Article to examine whether shareholder wealth maximization should be the only goal of managers.

erty,[2] Berle and Means argued that large public corporations are not controlled by their owners, the shareholders, but rather by managers, who are effectively immune from discipline by diffuse and disorganized groups of shareholders. Subsequent theorists have focused on two main issues identified by Berle and Means: (1) the extent and legitimacy of managerial discretion and (2) the ability and willingness of shareholders to monitor and discipline managers. Over time different theories have been proposed to illuminate these issues.

One such view is "managerialist" theory, which grew out of Berle and Means's findings and was influential until the mid-1970s.[3] Managerialists assert that managers enjoy too much discretion, especially with respect to decisions regarding investments and the distribution of corporate profits. For example, managers' interest in maximizing their compensation[4] gives them an incentive to choose investment projects that will increase the size of the firm, even if these decisions will not maximize shareholder wealth.[5] While managerialists recognize that managers are subject to the disciplining effect of some market and non-market constraints,[6] they see these constraints as very weak.[7] Legal academics holding a managerialist view contend that managerial discretion should be curbed through greater legal intervention.[8]

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2 ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

3 Managerialist theory is now enjoying a revival of sorts in some quarters. *See, e.g.*, JOSEPH E. STIGLITZ & AARON S. EDLIN, DISCOURAGING RIVALS: MANAGERIAL RENT SEEKING AND ECONOMIC INSUFFICIENCIES (National Bureau of Economic Research Working Paper No. 4145, 1992).

4 This includes both pecuniary and nonpecuniary compensation, such as corporate perquisites and greater power, prestige, and leisure. *See generally* ROBIN MARRIS, THE ECONOMIC THEORY OF "MANAGERIAL" CAPITALISM 46-109 (1964) (analyzing the economic, sociological, and psychological motivations of corporate managers).

5 In this respect, managerialist theory is in agreement with Michael Jensen's "free cash flow" theory. Where the theories differ is in Jensen's belief that the market for corporate control and the incurrence of corporate debt will lead to great reductions in the misuse of free cash flows. *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV., May 1986, at 323 [hereinafter Jensen, *Free Cash Flow*].

6 *See, e.g.*, WILLIAM J. BAUMOL, BUSINESS BEHAVIOR VALUE AND GROWTH 33-44 (1959) (managers are subject to a minimum profit constraint); Robin Marris, *A Model of the "Managerial Enterprise"*, 77 Q.J. ECON. 185 (1963) (the market for corporate control acts as a constraint).

7 In fact, managerialist literature usually takes managerial discretion as a given and focuses on identifying what goals managers actually pursue. *See* STIGLITZ & EDLIN, *supra* note 3.

8 *See* RALPH NADER ET AL., TAMING THE GIANT CORPORATION (1976); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1430-42 (1985) [hereinafter Brudney, *Corporate Governance*]; Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982).

The mid-1970s saw the development, by several economic and legal writers, of an agency theory of the firm.[9] Agency theorists agree with managerialists that managers have an incentive to maximize their compensation packages, but disagree with managerialists' claims that managers enjoy too much discretion, for which regulatory intervention is required. Agency theorists argue that market and contractual constraints greatly reduce managerial discretion, ultimately confining it to the optimal level in an imperfect world.[10] Legal academics who advance the agency theory of the firm argue that the legal intervention advocated by managerialists would generally make matters worse by interfering with the proper functioning of market and contractual mechanisms;[11] according to agency theorists, the "problem" of shareholder apathy identified by managerialists is merely a "rational" reaction to the collective action problems[12] inherent in shareholder voting.[13]

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9 For a more detailed discussion of the agency theory of the firm and its weaknesses, see *infra* part I.

10 Agency theorists reach this conclusion because, unlike neoclassical economic theorists, they assume a world with positive monitoring and enforcement costs. Failure to do that would be committing what they call the "Nirvana Fallacy." *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 328 (1976) (citing Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J.L. ECON. 1 (1969)).

11 *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 34-35 (1991) [hereinafter EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE] (corporate law is characterized as a set of "off-the-rack" rules that help supplement, but not displace, actual bargains: "The law completes open-ended contracts. There is no reason why it should be used to impose a term that defeats actual bargains or reduce the venturers' joint wealth").

12 For example, a shareholder who owns 5% of the stock of a corporation that she believes is being mismanaged can spend her own money to wage a proxy fight to replace the board of directors. While she bears the whole cost of waging the proxy fight, she only receives a 5% share of any increase in value of the corporation brought about by the change in the composition of the board. More importantly, however, the other shareholders will receive 95% of the gain even though they did not contribute to the proxy fight. The gain in corporate value is a collective good to be shared pro rata by all of the shareholders. As a result, no shareholder has an incentive to incur any expenses to carry out the proxy fight (unless its pro rata share of the collective good exceeds its cost of waging the proxy battle). Instead it makes sense to wait and take a free ride on the actions of other shareholders; the end result is that no shareholder takes any action. *See generally* MANCUR OLSON, JR., THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1965).

13 During the last five years, several commentators have formulated an "overregulation" theory to account for the continued apathy of shareholders. These commentators have focused on the possibility of circumventing this collective action problem now that large amounts of the equity of large corporations are in the hands of institutional investors who could feasibly cooperate in the voting process; they have also addressed the continued reluctance of many institutional investors to become involved in the voting process. *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990) [hereinafter Black, *Shareholder Passivity*]; Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

The collapse of the takeover market, the rise of institutional investor activism, and other changes[14] have recently altered the character of the relationship between shareholders and managers. As a result, it is an opportune time to reevaluate the received theories of the firm[15] to account for these changes.[16]

The purpose of this Article is to introduce concepts and paradigms that have been developed in the game theory literature—particularly in the theory of bargaining—to refocus the analysis on the

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These writers argue that a number of political roadblocks prevent shareholders from exercising a more powerful voice in shareholder voting. These roadblocks, mostly in the form of federal and state regulations, have made it difficult for institutional investors to acquire large equity stakes in companies. Commentators have proposed that regulatory constraints be relaxed to make it easier for institutional investors to increase the size of their equity holdings, thereby increasing their participation in the shareholder voting process. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 816 (1992) [hereinafter Black, *Agents Watching Agents*]; Black, *Shareholder Passivity*, *supra*, at 580. I do not discuss the "overregulation" theory in this Article, since the main concern of that theory has been to identify the legal constraints on shareholder activism, rather than to set forth a coherent theory of the firm. I deal with the "overregulation" theory in another article. *See* Manuel A. Utset, *Disciplining Managers: Shareholder Cooperation in the Shadow of Shareholder Competition*, 44 EMORY L.J. 71 (1995).

14 *See infra* notes 120-21 and accompanying text.

15 My goal, in particular, is to revisit the agency theory of the firm in the hopes of reexamining some of its assumptions and limitations, which with time and acceptance have faded into the background. Charles Taylor sets forth the program for such an undertaking:

> If one tries to identify the reasons . . . why certain views have to fight for credence, how they can only acquire plausibility through creative redescription while others are so to speak credible from the start, the answer is to be found in the background of practices . . . and the nature of their organizing principles. These are of course never monolithic; but in a given society at a given time, the dominant interpretations and practices may be so linked with a given model that this is, as it were, constantly projected for the members as the way things obviously are. . . . [F]reeing oneself from the model cannot be done just by showing an alternative. What we need to do is to get over the presumption of the unique conceivability of the embedded picture. But to do this, we have to take a new stance towards our practices. Instead of just living in them and taking their implicit construal of things as the way things are, we have to understand how they have come to be, how they came to embed a certain view of things.

Charles Taylor, *Philosophy and Its History*, *in* PHILOSOPHY IN HISTORY 17, 21 (Richard Rorty et al. eds., 1984).

16 For example, in a recent article, Professor Coffee argues that "[a]s the takeover wave of the 1980s ebbs, a siguificant shift now appears to be in progress in the way the public corporation is understood." John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1278 (1991) [hereinafter Coffee, *Liquidity Versus Control*]. According to Coffee, the shift is away from the agency theory of the firm, identified as the "old paradigm," to one that, among other things, "emphasizes that political forces shaped the modern corporation." *Id.* at 1278. The other force that has been identified as contributing to a paradigm shift is the increased concentration of equity securities in the hands of institutional investors, coupled with an increased interest by these investors in becoming active in corporate governance. *See* Dr. Carol Kay Brancato & Patrick A. Gaugham, Institutional Investors and Capital Markets: 1991 Update (Columbia Institutional Investor Project, Center for Law & Economic Studies, Columbia University School of Law, Sept. 1991); Black, *Shareholder Passivity*, *supra* note 13, at 567-72.

dynamic nature of the shareholder-manager relationship, and, in particular, to underline the role of the strategic behavior of the parties. The bargaining paradigm provides a framework for analyzing how the possibility—and actuality—of cooperation and conflict influence the way that shareholders and managers act: how they approach problems, gather information, make decisions, and carry them to fruition.[17]

This Article takes the received agency theory of the firm as a stalking-horse. The goal is not to refute or undermine the received agency theory, but rather to shake off some of the underlying assumptions that have restricted the objects to which the theory has attended. The agency theory of the firm is an offshoot of the more general agency theory developed in the economic literature.[18] Like any economic model, it takes the perfectly legitimate position that its object of analysis is limited in nature: the goal is to capture the essence of certain interactions, not to mirror reality.

The agency theory of the firm has provided very valuable insights. In particular, it has set a solid background for the study of how informational asymmetries affect manager-shareholder relations; of the role of compensation schemes in aligning managerial incentives with those of shareholders; and of the role of market, contractual, and regulatory constraints in shaping the interactions of the parties involved. Two insights of agency theory are particularly helpful: (1) it does not make economic sense, in a world of incomplete information, to expend resources to make managers act in the same exact way that they

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17 A more complete analysis of the bargaining context within the firm would include as players other economic actors in the firm, such as creditors, employees, and board members. The bargaining theory in this Article will hopefully provide a model that can eventually be expanded to include these other constituencies. Some work has already been done in modelling bargaining by creditors and employees. *See* MASAHIKO AOKI, THE CO-OPERATIVE GAME THEORY OF THE FIRM (1984) [hereinafter AOKI, CO-OPERATIVE GAME THEORY] (bargaining between shareholders and employees with managers as mediators); GARY J. MILLER, MANAGERIAL DILEMMAS: THE POLITICAL ECONOMY OF HIERARCHY (1992) (bargaining between managers and employees); Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEGAL STUD. 311 (1991) (bargaining in the bankruptcy context); John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495 (1990) [hereinafter Coffee, *Unstable Coalitions*] (shareholder bargaining in the takeover context); Harvey Leibenstein, *The Prisoners' Dilemma in the Invisible Hand: An Analysis of Intrafirm Productivity*, 72 AM. ECON. REV. 92 (Papers & Proceedings, May 1982) (bargaining between employees and managers).

18 A principal attraction of agency theory is its generality. An agency problem can be deemed to arise any time one individual depends on the actions or behavior of another individual. *See* John W. Pratt & Richard J. Zeckhauser, *Principals and Agents: An Overview*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 1, 2 (John W. Pratt & Richard J. Zeckhauser eds., 1985) [hereinafter PRINCIPALS AND AGENTS]. Using various assumptions about the incentives of economic actors and the ways those incentives can be reshaped through contractual and market constraints, agency theorists have developed sophisticated theories explaining how individuals in an agency relationship can coordinate their interactions.

would have acted if they had been principals instead of agents; and (2) market and contractual constraints are frequently cheaper and more effective than regulatory constraints.

A useful exercise with any economic model is to compare its assumptions with the real world. Although a one-to-one correspondence is not the goal, there are obvious constraints on the liberties one can take with any model's assumptions. Assumptions that become questionable may be relaxed to see if the model still reaches similar conclusions. As mentioned above, recent changes have brought into question the empirical bases for some of the key assumptions of the agency theory of the firm. Part of the methodological difference between the bargaining theory that I propose and the received theory arises from a retooling of the underlying assumptions of the agency theory of the firm.

Specifically, bargaining theory starts with three observations. First, in contrast to agency theory, bargaining theory holds that the market and contractual constraints on managerial discretion are not terribly effective, especially given the collapse of the takeover market.[19] Unlike managerialist theory, however, bargaining theory does not conclude that the principal solution to this problem should be heightened legal intervention. Rather, one goal of bargaining theory is to better understand market constraints and the way they are manipulated by managers, in the hopes of eventually making these constraints more robust through both contractual and legal provisions.

Second, shareholders, particularly institutional investors, are becoming increasingly involved in corporate governance.[20] This conflicts with both the managerialist view that shareholders do not have adequate legal protection to become more involved and the agency theory view that shareholders have no interest in such involvement.

Third, managers use their discretion not only to increase their compensation packages, but also to increase their bargaining power in anticipation of future bargaining rounds with shareholders. Their discretion enables managers to shape the relevant legal and nonlegal institutions affecting their relationship with shareholders, to change

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19 STIGLITZ & EDLIN, *supra* note 3, at 2-3 ("[I]t is now recognized that neither the takeover mechanisms nor the shareholder-voting mechanism may exercise effective discipline.... At this point, the theoretical puzzle is not so much how to explain the existence of managerial discretion, but to explain the existence of managerial discipline."). For a more detailed critique of the agency theory assumption of market discipline, see *infra* part I.

20 *See* Brancato & Gaugham, *supra* note 16; Black, *Shareholder Passivity*, *supra* note 13, at 567-75. Although increased institutional investor activism lends support to the bargaining theory of the firm, I argue in Part II that, even in times of little shareholder activism, it makes sense to view shareholder-manager relations as an ongoing bargaining game.

shareholder perceptions and preferences, and to use their control over the production and distribution of information to gain strategic advantages. These mechanisms make it more costly for shareholders to remove managers, who can therefore become more entrenched. This ongoing preparation for bargaining yields certain costs and inefficiencies that neither managerialist nor agency theory addresses. In addition, it requires a reconceptualization of our notions of managerial discretion and the ways of controlling it.

This Article places bargaining at the forefront of the picture of corporate interactions.[21] While theorists who advocate the received agency theory of the firm do refer to the relationship between shareholders and managers as part of a set of implicit and explicit contracts—and thus as the product of some sort of bargain—their confidence in the efficacy of market and contractual constraints obscures the need for a close examination of the bargaining context.[22] For example, William Klein writes that "[t]he theory [he] develop[s] does not necessarily assume that people engage in bargaining. . . . [O]ne can think in terms of a bargain (an outcome) rather than bargaining (a process)."[23] This Article begins a closer study of bargaining among the different actors in the firm, in the hopes of better understanding how they interact—how they come into conflict, learn to cooperate, and calculate the costs and benefits of conflict and cooperation (including the infrequently examined costs of cooperation and benefits of conflict). I explicitly analyze process in order to better understand outcomes.

In general, a bargaining context is one in which two or more parties negotiate regarding the possibility of cooperating in some venture.[24] The standard bargaining problem is one in which (1) the parties are in a position to reach an agreement beneficial to both, (2) conflict exists as to which agreement to reach, and (3) neither party may unilaterally impose an agreement on another without its approval.[25]

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21 This leads to other methodological differences, such as focusing on: (1) the strategic behavior of managers and shareholders; (2) the bargaining costs produced by such strategic behavior; (3) the dynamic, ongoing nature of the shareholder-manager relationship; (4) the role of managerial discretion and informational asymmetries in this relationship; and (5) the issue of institutional emergence and change.

22 *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989) [hereinafter Easterbrook & Fischel, *The Corporate Contract*].

23 William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1522 (1982).

24 *See* John C. Harsanyi, *Bargaining*, *in* 1 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 190, 190 (John Eatwell et al. eds., 1987) [hereinafter THE NEW PALGRAVE]; John F. Nash, Jr., *The Bargaining Problem*, 18 ECONOMETRICA 155, 155 (1950).

25 MARTIN J. OSBORNE & ARIEL RUBENSTEIN, BARGAINING AND MARKETS 1 (1990).

The shareholder-manager context satisfies these criteria.[26] Shareholders and managers can create a bargaining surplus by cooperating with one another, and there are multiple ways of structuring their interactions to obtain this surplus. Given that different agreements will have different distributional outcomes, there is conflict about which agreement to reach. Furthermore, since managers and shareholders always retain the option of exiting the corporation, neither can impose an agreement without the assent of the other.

A simple example will illustrate some of the issues that can arise in shareholder-manager relations in a bargaining context. Assume that C & C, Inc. is a large public corporation.[27] State corporation laws give shareholders little power to run a corporation; this task is reserved for the board of directors and the managers selected by the board.[28] In a sense, by taking responsibility for the firm's day-to-day operations, the directors and managers of C & C, Inc. act as agents of the shareholders. To the extent that managers and shareholders cooperate in this enterprise (shareholders by providing capital and managers by providing their managerial expertise), both will be better off.

I will adopt the usual assumption that the shareholders of C & C want to maximize their wealth by maximizing (1) the share price of C & C stock and (2) distributions by the corporation, such as dividends. Managers, by contrast, want to maximize (1) the amount of corporate resources they appropriate for their own use (by means of salaries, corporate perquisites, and other direct or indirect remuneration) and (2) the amount of leisure or shirking they enjoy.[29] Manager and shareholder goals conflict because an increase in management remuneration or leisure will come out of resources that would otherwise belong to shareholders. Since managers are empowered to make cor-

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26 The bargaining game that I have in mind is one in which shareholders and managers are trying to divide certain substantive and procedural stakes. A bargaining region exists because managers are not subject to a contract that sets *ex ante* their exact compensation and the way they can act. Furthermore, the market constraints that would otherwise limit a manager's bargaining power are not very effective. *See infra* notes 49-65 and accompanying text.

27 In this Article, I focus on the corporate governance issues that arise in public corporations. Small close corporations, in which bargaining among shareholders and managers is more common, raise different corporate governance issues that I do not address. For an overview of these issues, see F. HODGE O'NEAL & ROBERT B. THOMPSON, CLOSE CORPORATIONS (3d ed. 1994); F. HODGE O'NEAL & ROBERT B. THOMPSON, OPPRESSION OF MINORITY SHAREHOLDERS (2d ed. 1994).

28 Shareholders elect the members of the board of directors and thus indirectly affect corporate policy. *See, e.g.*, DEL CODE ANN. tit. 8, §§ 141, 211, 214, 216 (1993). In addition, shareholders must approve a number of other transactions. These include mergers, the sale of all or substantially all of the assets of the corporation, and the amendment of the certificate of incorporation. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 242(c), 251(c), 271(a), 275(b) (1993).

29 These are the traditional assumptions in both agency theory and managerialist theory. *See* Jensen & Meckling, *supra* note 10, at 312-13.

porate decisions, including how much they will pay themselves, shareholders must incur costs to monitor and discipline them.[30]

Next, assume that C & C has suffered financial losses during the last five years, but the company's managers have continued to give themselves raises, a scenario that is not too uncommon. What can the shareholders of C & C do to remedy the situation? What would we expect them to do? Although questions like these may seem easy to resolve (for example, shareholders might replace the managers), these problems have been at the center of the corporate governance debate ever since Berle and Means.

Both the agency theory of the firm and the bargaining theory developed in this Article provide answers to these questions. Agency theory provides answers that may be theoretically sound, but which, in many areas, provide only broad guidance and prescriptions. Bargaining theory attempts to focus our attention on dynamic and strategic interaction among the parties. Managerial discretion provides ample room for strategic maneuvering—in short, for bargaining. Understanding these interactions is critical for regulators, for shareholders deciding whether to use the "exit" or "voice" strategy, and for managers trying to make a good living while keeping their jobs.

In a sense, while agency theory views shareholder-manager interactions through the naked eye, bargaining theory tries to look at these interactions through a microscope. Sometimes seeing more is counterproductive. But as the medical gaze is sometimes undertaken by the naked eye, it is at other times fixed on the microscope. Knowing how to look is of critical importance; knowing that there are different ways of looking at the same phenomena is equally important. Bargaining theory simply provides a different way to look at shareholder-manager relations. It does not advocate that you get rid of your old pairs of glasses; rather, it tries to give you a more finely ground lens.

Part I discusses the agency theory of the firm in greater depth. It examines the principal assumptions of the theory and offers an evaluation of the theory, keeping in mind the different contexts in which the theory is usually deployed. Part II develops a bargaining theory of

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30 An economic actor trying to produce certain outputs has two alternatives: she can act on her own behalf or she can delegate to an agent and incur the costs of monitoring the agent. The classic example is the division of labor in Adam Smith's pin factory. *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 5-6 (Edwin Cannan ed., 6th ed. 1950) (1904). Adam Smith also had something to say about the monitoring problem:

> The directors of [joint stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.

Id. at 700.

the firm. It first sets forth the stakes over which the parties bargain and then discusses the reasons why shareholders and managers engage in the bargaining process. It concludes by looking at the mechanics of bargaining. It discusses the nature of the bargaining interaction and the bargaining asymmetries that one would expect to arise, and concludes by looking at certain inefficiencies arising from the bargaining interaction. Part III examines certain applications and prescriptions suggested by bargaining theory. The final section offers some conclusions.

I
THE AGENCY THEORY OF THE FIRM

As mentioned above, this Article uses the agency theory of the firm as a springboard. The goal is not to refute agency theory. Instead, this Part offers an account of the principal aspects of the agency theory of the firm and then offers a critique that aims at identifying the limits of that theory's applicability. Getting a better understanding of the limitations of the agency theory of the firm will provide guidance on when we would want to deploy that theory. This analysis sets the stage for an examination of the bargaining theory of the firm and the circumstances in which it provides a better explanation than the agency theory of the firm.

A. An Overview

In the last fifteen years, agency theory has emerged as the dominant theory of the firm among economists[31] and legal academics.[32] Before providing agency theory with a technical overlay, we can take

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31 *See* Coffee, *Unstable Coalitions*, *supra* note 17, at 1495. For a discussion of the agency theory of the firm by the principal theorists responsible for its development, see Jensen & Meckling, *supra* note 10, at 308-10; Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 288-89 (1980); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Michael C. Jensen, *Organization Theory and Methodology*, 58 ACCT. REV. 319, 326-32 (1983) [hereinafter Jensen, *Organization Theory*]; Michael C. Jensen & Gerald L. Zimmerman, *Management Compensation and the Managerial Labor Market*, 7 J. ACCT. & ECON. 3, 4-5 (1985).

32 *See* EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 9-11; PRINCIPALS & AGENTS, *supra* note 18; Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U. L. REV. 99, 108-10 (1989); Klein, *supra* note 23; Easterbrook & Fischel, *The Corporate Contract*, *supra* note 22, at 1426-28; Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 700-03 (1982) [hereinafter Easterbrook & Fischel, *Control Transactions*]; Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 401 (1983) [hereinafter Easterbrook & Fischel, *Voting*]; Fama & Jensen, *supra* note 31, at 301; Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1261-65 (1982).

Agency theory has not been free from attack, especially among legal academics. Many of these critiques have come from commentators who believe that the agency paradigm does not really describe the legal framework under which shareholders and managers interact. *See, e.g.*, Brudney, *Corporate Governance*, *supra* note 8, at 602-07; Coffee, *Unstable Co-*

stock. Shareholders hire managers to run the corporation. These managers can act more effectively if they have a certain degree of discretion in running the business and if they are not second-guessed each time they make a decision. Managers will largely control the production and dispersion of information regarding their own performance and that of the business. Shareholders will find it difficult to overcome the collective action problem in carrying out proxy fights to remove managers. However, certain market constraints, such as the market for corporate control and the market for managers, will help rein in recalcitrant and underperforming managers. Furthermore, tying managers' compensation to the performance of the firm or making them equityholders makes their actions more consistent with the interest of shareholders.

Agency theory developed in response to neoclassical economic theory[33] and managerialist theory.[34] Rather than viewing the firm as a neoclassical "black box," agency theory recognizes the conflicting interests of shareholders and managers. The firm of agency theory is no longer the neoclassical firm in which the only role of managers is to choose the set of inputs and outputs that maximizes firm profits. Although managers are still deemed to make production decisions, agency theory adopts the managerialist assumption that managers are

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alitions, *supra* note 17, at 1495 n.1 (Focusing on agency theory overlooks "the degree to which other actors can influence or form alliances with the agent.").

33 Neoclassical theory does not focus on the different actors involved in the production of goods through the firm. Instead it views the firm as an entity with a coherent purpose—maximizing profits—subject to certain technological constraints. DAVID M. KREPS, A COURSE IN MICROECONOMIC THEORY 4 (1990). In other words, the firm is envisioned as a "black box" through which inputs are transformed into outputs. The difference between the cost of producing a good (the input costs) and the revenue from the sale of such a good will constitute either a profit or loss. *See* JAMES M. HENDERSON & RICHARD E. QUANDT, MICROECONOMIC THEORY: A MATHEMATICAL APPROACH 64 (3d ed. 1980).

Neoclassical theory assumes that production will be coordinated through the market, management's only task being to choose the amount of inputs and outputs that will maximize profits. *See* Harold Demsetz, *The Theory of the Firm Revisited*, *in* OWNERSHIP, CONTROL, AND CAPITAL (Harold Demsetz ed., 1988). As Coase pointed out, however, neoclassical theory fails to take into account that some production is coordinated through firms and not through the market. Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 386-89 (1937). According to Coase, production through the firm is coordinated by an entrepreneur (or manager) who directs production by fiat: an "entrepreneur" in a competitive market system is a person who "take[s] the place of the price mechanism in the direction of resources." *Id.* at 388 n.2.

34 Managerialist theory challenges the neoclassical assumption that managers will strive to maximize shareholder wealth at the expense of maximizing their own wealth. *See, e.g.*, Robin Marris & Dennis C. Mueller, *The Corporation, Competition, and the Invisible Hand*, 18 J. ECON. LIT. 32, 41 (1980) ("Both the static and growth variants of the managerial model assume that managers are capable of exercising a claim on a significant share of firm profits.").

utility-maximizers who do not always act in the best interests of shareholders.[35]

Critical to understanding agency theory is understanding the role played by informational asymmetries in shareholder-manager relations. Shareholders delegate certain decisionmaking authority to managers, who are engaged to run the firm.[36] In the day-to-day operation of the firm, managers make decisions on behalf of shareholders. Two important types of decisions are (1) decisions regarding how much effort managers will put into managing the company and (2) decisions regarding investment and operating strategy (decisions that managers make based on information available only to them and not to shareholders).[37] The outcomes of managerial decisions are affected, but not completely determined, by the actions of managers.[38] Shareholders are therefore unable to discern whether financial losses were caused by the self-interested actions of managers or by exogenous factors.[39] Thus, it is impossible, at zero cost, to ensure that managers act in the same way as the shareholders would act if they were making the decisions with the same information and capabilities as the managers.[40]

Also important to understanding the agency theory of the firm is understanding the role played by contract. The agency relationship between shareholders and managers is contractual in nature.[41] Like most contractual relationships, it involves a combination of cooperation and competition (that is, self-interested behavior). The costs incurred by both shareholders and managers to close the gap between

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35 Because production decisions will be affected by managerial self-interest, they may not result in outcomes that are optimal from the shareholders' point of view. *See* Jensen & Meckling, *supra* note 10, at 308.

36 *See* DEL. CODE ANN. tit. 8, §§ 141(a), 142 (1993).

37 We are concerned with two types of asymmetric information: (1) "hidden actions" by managers—that is, only managers know how much effort they are putting into managing the company; and (2) "hidden information"—information about the company that only managers and not shareholders possess. *See* Kenneth J. Arrow, *The Economics of Agency*, *in* PRINCIPALS & AGENTS, *supra* note 18, at 37, 38-42.

38 Technically, the outcome is a random variable whose distribution depends on the actions taken by the manager. *See id.* If this were not the case, then the agency problem could be solved by paying the agent according to the observed outcome, which by definition would he a function solely of the manager's actions.

39 *See* Joseph E. Stiglitz, *Principal and Agent (ii)*, *in* 3 THE NEW PALGRAVE, *supra* note 24, at 966, 967 ("The principal-agent literature focuses on situations where an individual's actions can neither be observed nor be perfectly inferred on the basis of observable variables; thus, for instance, it is usually assumed that output is a function of effort and an unobservable random variable.").

40 *See* Jensen & Meckling, *supra* note 10, at 308; Arrow, *supra* note 37, at 39.

41 The contract between shareholders and managers is part of the nexus of contracts of agency theory. *See* Butler, *supra* note 32, at 99; Easterbrook & Fischel, *The Corporate Contract*, *supra* note 22, at 1418; Jensen, *Organization Theory*, *supra* note 31, at 326; Jensen & Meckling, *supra* note 10, at 311; Klein, *supra* note 23, at 152.

the way shareholders want managers to act and the way managers do act are referred to as "agency costs."[42] The goal of agency theory is to explain how certain contractual and market constraints help reduce agency costs to the optimal level.

Agency theory assumes that, since one or both of the parties (that is, shareholders and managers) can capture the benefits of reducing agency costs, they have an incentive to minimize agency costs[43] by adopting certain incentive structures[44] and by incurring bonding[45] and monitoring costs. Agency theory posits that, in the end, an equilibrium point[46] will be reached in which the marginal cost to shareholders and managers of incurring greater monitoring and bonding costs equals the marginal gain from reducing the residual loss.[47]

This equilibrium outcome will be optimal as a second best solution. In other words, it is not the optimal outcome if we compare it to a world with complete and costless information that can be completely processed by the parties. Unlike neoclassical economic theorists, agency theorists argue that comparing actual outcomes with ideal world outcomes would be committing the Nirvana fallacy.[48]

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42 If contracts between principals and agents could be written and enforced at no cost, then such a gap would not exist. However, there are costs at the formation, administration, and enforcement stages of the contract, including bonding, monitoring, and residual costs. *See* Fama & Jensen, *supra* note 31, at 304; Smith, *supra* note 30, at 39.

43 *See* Pratt & Zeckhauser, *supra* note 18, at 6; Jensen, *Organization Theory*, *supra* note 31, at 331.

44 One way of closing the gap between managerial and shareholder interests is by tying managerial compensation to the economic performance of the firm (*e.g.*, paying with share options, whose value will increase with increases in share value). *See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 64-66 [hereinafter Jensen, *Eclipse*]; Jensen & Zimmerman, *supra* note 31, at 4-6. *But see* George P. Baker et al., *Compensation and Incentives: Practice vs. Theory*, 43 J. FIN. 593, 613-15 (1988) (identifying barriers that prevent principals and agents from structuring efficient compensation plans that tie managerial compensation to the firm's economic performance).

45 Managers incur bonding costs to guarantee that they will not take certain actions and will compensate shareholders if they do. *See* Jensen & Meckling, *supra* note 10, at 308. They incur these costs to make it less costly for them to raise capital for the firm, given that the equity market will anticipate the expected agency costs. *Id.* at 313.

46 Agency theory responds to the "separation of ownership and control" thesis advanced by Berle & Means, *supra* note 2, at 69-118, by positing that market mechanisms will discipline management until an equilibrium point is reached in their contractual relationship. Agency theory views the contractual relationship between shareholders and managers as one more akin to a relationship among participants in a market transaction (i.e., "the outcome of a complex equilibrium process"), than to one among members of an economic organization. *See* Jensen & Meckling, *supra* note 10, at 310-11.

47 *See* Jensen & Meckling, *supra* note 10, at 328. Since shareholders cannot monitor and enforce managers' actions at zero cost, a point will be reached where expending an additional dollar in monitoring and enforcement will reduce agency costs by an amount less than one dollar. At such an equilibrium point, shareholders bear the optimal amount of monitoring costs and managers the optimal amount of bonding costs. While there will still be a residual loss, the loss is minimized at the equilibrium point. *Id.*

48 *See* Pratt & Zeckhauser, *supra* note 18, at 3. The separation of ownership and control produces outcomes that are optimal only as a second-best solution. That is, they are

B. Assumptions of the Agency Theory of the Firm

This section analyzes three main assumptions of the agency theory of the firm by looking at the role and effectiveness of market, contractual, and evolutionary constraints on managerial discretion. These constraints have a certain amount of force. How much actual force is an empirical question that is beyond the scope of this Article. The goal of this section is to bring into question the robustness of some of these constraints and to recognize that there is room for maneuvering in how these constraints are identified, measured, and used. We do not have to prove that these constraints are nonexistent, but merely that there is room for maneuvering—for strategic behavior—and thus that there is a shortfall in the explanatory power of agency theory.

1. *The Effectiveness of Market Constraints*

One assumption of the agency theory of the firm is that managers minimize agency costs because they are constrained by certain markets.[49] According to Easterbrook and Fischel, "Managers may do their best to take advantage of their investors, but they find that the dynamics of the market drive them to act as if they had investors' interests at heart."[50] Let us now look more carefully at these markets and at their weaknesses as constraining mechanisms.[51]

Agency theory relies on the market for corporate control as the principal market constraint on managerial discretion.[52] Since the late

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optimal only if one compares them to those produced in a non-ideal world, a world where information is incomplete and costly. *See* EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 106 (Nirvana fallacy of comparing imperfect markets against a mythical perfect judicial or regulatory scheme); Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 273 (1986); Jensen & Meckling, *supra* note 10, at 328.

49 *See* Jensen & Meckling, *supra* note 10, at 328.

50 EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 4. *See also* Butler, *supra* note 32, at 122 ("Market forces constrain managers to act *as if* they have the shareholders' interests at heart; which is all that can be expected.").

51 *See* DONALD A. HAY & DEREK J. MORRIS, INDUSTRIAL ECONOMICS AND ORGANIZATION: THEORY AND EVIDENCE (2d ed. 1991); STIGLITZ & EDLIN, *supra* note 3, at 2-3 (indicating that the market and shareholder voting constraints on management are so weak that the theoretical difficulty lies in explaining discipline rather than discretion); Black, *Agents Watching Agents*, *supra* note 13, at 825-26; Coffee, *Liquidity Versus Control*, *supra* note 16, at 1279.

52 Robin Marris was the first to introduce the idea of the market for corporate control as a disciplining mechanism. *See* ROBIN MARRIS, THE ECONOMIC THEORY OF "MANAGERIAL" CAPITALISM 18-22 (1964); Marris, *supra* note 6, at 185-91. However, it was Henry Manne who first saw the market for corporate control as a substantial constraint on managerial discretion. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-14 (1965). During the takeover boom in the 1980s, agency theorists picked up the concept to support the agency theory of the firm. *See, e.g.*, William J. Carney, *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, 1988 WIS. L. REV. 385; Easterbrook & Fischel, *Control Transactions*, *supra* note 32, at 705-08; David

1980s,[53] however, the market for corporate control has lost most of its disciplining power.[54] In fact, many theorists view the rise of shareholder activism as a reaction to the demise of the market for corporate control.[55]

The market for managers is another market constraint.[56] A manager who imposes high agency costs on shareholders would find it harder to change companies, either voluntarily or after being dismissed by the current company.[57] One limitation on the proper workings of the market for managers is a problem experienced in any type of production team (such as a team of managers): it is hard to discern which manager is underperforming or causing the increase in agency costs.[58] Furthermore, the market for managers, just like other labor markets, is bound to be imperfect.[59] For one thing, if managers can-

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D. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701, 727-28, 737-39 (1987); Jensen, *Free Cash Flow*, *supra* note 5, at 324-28.

53 Even at the time of highest takeover activity, during the mid to late 1980s, some theorists questioned the viability of the market for corporate control as a disciplining mechanism. This is because of free rider problems and managers' use of antitakeover mechanisms. *See* HAY & MORRIS, *supra* note 51, at 531.

54 The reasons for the demise of the market for corporate control are many. They include the following: (1) the collapse of the "junk bond" market; (2) the adoption by many states of takeover statutes; (3) the improvements in certain antitakeover mechanisms; and (4) the overall decline in economic performance that led to the bankruptcy of some of the big companies that had been saddled with large amounts of debt following takeovers (for example, the Macy and Campeau bankruptcies). *See* STIGLITZ & EDLIN, *supra* note 3, at 2; Coffee, *Liquidity Versus Control*, *supra* note 16, at 1279.

Some theorists, such as Michael Jensen, had gone so far as to proclaim the death of the public corporation and its replacement by highly leveraged private companies (that is, those resulting from leveraged buy-outs (LBOs)). *See, e.g.*, Jensen, *Eclipse*, *supra* note 44, at 61. For a critique of Jensen's view, see Alfred Rappaport, *The Staying Power of the Public Corporation*, HARV. BUS. REV., Jan.-Feb. 1990, at 96; Letters to the Editor, *The Public Corporation: Viewing the Eclipse*, HARV. BUS. REV., Nov.-Dec. 1989, at 182-208 (responding to Jensen). Jensen's theory has lost most of its explanatory power with the collapse of the LBO market.

55 *See* Coffee, *Liquidity Versus Control*, *supra* note 16, at 1279-80; Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach To Corporate Law*, 60 CINN. L. REV. 347, 347 (1991).

56 The seminal article is Fama, *supra* note 31.

57 *See id.* at 292. Many managers will never want to change companies, unless, of course, they lose their job through a proxy fight or a takeover.

58 For a discussion of the problems that arise in monitoring individual performance when the individual is part of a team, see Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 778-83 (1972); *see also* Roy Radner, *Team Decision Problems*, 33 ANNALS MATHEMATICAL STAT. 857 (1962) (analyzing how a team of decisionmakers working within a firm, but with differing responsibilities and information, reaches collective decisions); Roy Radner, *Teams*, *in* 4 THE NEW PALGRAVE, *supra* note 24, at 613, 613-16 (summarizing team decisionmaking theory).

59 The imperfection arises in part for the same reason that we have agency problems in shareholder-manager relations: It is not possible to tell whether a certain outcome is a product of the manager's effort or some random variable. Furthermore, managers may acquire company-specific information that makes them "quasi monopolistic suppliers of managerial skills to the firm." HAY & MORRIS, *supra* note 51, at 308.

not be easily removed from their current jobs, they will not have to face the discipline of the market unless they so choose. All these factors limit the efficacy of the market for managers as a constraint on managerial behavior.[60]

The market for a company's product is a more indirect constraint on managers.[61] If a company's managers spend too much time shirking, divert excess amounts of the net organizational revenues to themselves, misinvest free cash flows, or make capital investments for solely strategic purposes, the company will suffer in the products market. Whether this market will adequately discipline managers will depend on the ability of outsiders to pinpoint the cause of a decline in demand for a company's product. If the cause is poor management, we would want to discipline the managers, but determining fault is difficult. More importantly, however, managers will have an incentive to act strategically to ensure that to outside observers it appears that the downturn was produced by some exogenous factor. The difficulty of relying on the products market is exacerbated in cases where the company's product enjoys market power.[62]

The capital markets also provide some constraints on managerial discretion.[63] A firm whose managers impose large agency costs will find it more difficult to raise capital through the equity markets. Potential shareholders will consider agency costs in valuing the firm and thus "price protect" themselves by paying less for the shares than they would for shares of a firm with lower agency costs.[64] Thus, raising capital will become costlier, leaving firms with high agency costs at a competitive disadvantage. The problem with this constraint is that in order for it to be effective, managers must continually tap into the capital markets. However, because managers have discretion to pay out cash flows (in the form of dividends) or to keep them as retained earnings, they will do the latter if they want to avoid the disciplining effect of the capital markets.[65]

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60 *Id.*

61 *See* Jensen & Meckling, *supra* note 10, at 329-30.

62 *See* HAY & MORRIS, *supra* note 51, at 305, 307; Timothy H. Hannan, *Expense-Preference Behavior in Banking: A Re-examination*, 87 J. POL. ECON. 891, 891 (1979). *But see* Jensen & Meckling, *supra* note 10, at 329 ("[F]irm[s] with monopoly power have the same incentives to limit divergences of the manager from value maximization.").

63 *See, e.g.*, Butler, *supra* note 32, at 114-15; Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 556-57 (1984); Jensen & Meckling, *supra* note 10, at 329.

64 *See* Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 14 (1989); Jensen & Meckling, *supra* note 10, at 306, 351.

65 In fact, this is the argument behind Michael Jensen's free cash flow theory. However, Jensen assumes that other market constraints, such as the market for corporate control, will lead managers to pay out funds, either as dividends, or, more likely, in the form of interest payments to debtholders. *See* Jensen, *Free Cash Flow*, *supra* note 5, at 323-24.

2. *The Effectiveness of Contractual Constraints*

Even if market constraints are not very effective, contractual arrangements can also limit managerial discretion. This section examines the role of contracts and governance structures in defining the relationship between shareholders and managers, and sets forth the limitations of agency theory's use of the contractual-governance paradigm.[66]

Contracts are useful for ordering relationships only to the extent that they are not systematically breached. Contracts enforced by third parties, such as governments (which have authority) or bat-wielding independent contractors (which merely have power),[67] or which are somehow self-enforcing,[68] are of this sort. Whether contracts are enforced by third parties or are self-enforcing depends to a large degree on whether the contracts are explicit or implicit.[69] In describing shareholder-manager contracts, I will refer to contracts enforced by third parties as explicit contracts and self-enforcing contracts as implicit contracts.[70]

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66 A number of legal academics—particularly those who reject the economic approach—have questioned the contractual approach. *See* Brudney, *Corporate Governance*, *supra* note 8; Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS, *supra* note 18, at 55; John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919 (1988). For a defense of the contractarian view, see Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990); Easterbrook & Fischel, *The Corporate Contract*, *supra* note 22; Jensen & Meckling, *supra* note 10, at 310-11.

67 *See generally* AUTHORITY (Joseph Raz ed., 1990) (containing several views concerning the concept of authority in ethics and political philosophy).

68 Contracts can be self-enforcing in numerous ways, but for our purposes three possibilities are relevant: (1) the parties can be constrained by market mechanisms; (2) the parties can be repeat players; and (3) the parties can possess certain internalized norms. *See* DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 12-15, 55-56 (1990).

69 By explicit contracts I mean contracts with terms that are agreed to ahead of time and which are specific enough to be enforced by third parties. By implicit contracts, I mean every other type of relationship that can be described as contractual, from expressed contracts where, given future uncertainties, the terms are not very well defined (that is, incomplete contracts and relational contracts) to implied "contracts" arising out of the parties' behavior. Taken to the extreme, "implicit contract" can refer to any voluntary arrangement, as opposed to one required by law. *See* EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 14 ("To say that a complex relation among many voluntary participants is adaptive is to say that it is contractual. . . . Voluntary arrangements are contracts."). Conceiving of every voluntary relationship as a contract diminishes most of the explanatory power of the concept. *See* Erich Schanze, *Contract, Agency, and the Delegation of Decision Making*, *in* AGENCY THEORY, INFORMATION, AND INCENTIVES 461, 464 (Gunter Bamberg & Klaus Spremann eds., 1989).

70 Of course, one can still conceive of implicit contracts that are enforced by third parties (*e.g.*, relational contracts). Relational contracts do not usually end up in court, however, because parties usually find it cheaper to rely on other forms of enforcement (or accommodation). *See* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 166 (1985) ("Extensive recourse to private ordering is hardly a paradox if the limits of contract and of the courts are recognized . . . . Inasmuch, moreover, as the benefits of

As a general rule, explicit contracts will be more difficult to breach, and, thus, will provide greater constraints on discretion than will implicit contracts. Explicit contracts, however, are not always available. When parties to a contract—such as shareholders and managers—are involved in a long term relationship, future uncertainties and other informational problems make it impossible to provide for all contingencies in the contract.[71] Given the nature of entrepreneurship and the changing conditions in capital and products markets, it is impossible (and undesirable) to provide for every future contingency in an explicit and complete contract governing the shareholder-manager relationship.[72] This means that shareholders and managers rely on implicit contracts which are self-enforcing at best. The contracts

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'continuing harmonious relations' . . . apply to organizations of all kinds, while the limits of courts for dealing with complex problems are everywhere severe, greater attention to the ways by which conflict is mitigated *ex ante* and to the range of formal and informal devices by which disputes are settled *ex post* is needed."); Stewart Macaulay, *Non-Contractual Relations in Business*, 28 AMER. SOC. REV. 55, 61 (1963). Easterbrook and Fischel argue that corporate law provides a set of "off-the-rack" terms to the implicit contract between shareholders and managers, some of which, such as fiduciary duties, are enforced through third-party mechanisms. EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 34.

71 These agency contracts can be characterized as long-term relational contracts. *See* Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1091 (1981); Ian R. Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691, 720 (1974). Doing so does not help very much, however, because it merely points out that managers and shareholders are involved in a long term relationship. Unlike relational contracts in commercial transactions, in most cases these agency contracts are implicit contracts that are not enforceable in the same way as traditional contracts under contract law. The explicit contract set forth in the corporate charter does not provide for much more than the amount and type of shares issued and the name and addresses of the corporation, the incorporators, and the agent for service of process. *See* DEL. CODE ANN. tit. 8, § 102 (1993). Although charters can provide more information, they do so only rarely, if ever. *Id.*

Klein argues that one way to solve some of the problems of the agency paradigm is to establish long term contracts between managers and shareholders. Klein, *supra* note 23, at 1525. He readily admits, however, that such contracts have many limitations, including the difficulty in preventing managers from leaving the corporation and the fact that long term contracts exacerbate the moral hazard problem. *Id.* at 1546-48 n.91.

Falling back on the default rules that corporate law provides to fill the gaps in this "contract" is not very helpful because the law merely sets certain parameters to define the bargaining context. For example, corporate law can be seen as setting certain broad limitations on the bargaining power of shareholders and managers. Part III of this Article analyzes this function of the law in more depth.

72 *See* WILLIAMSON, *supra* note 70, at 29 ("Transaction cost economics maintains that it is impossible to concentrate all of the relevant bargaining action at the *ex ante* contracting stage"; this is due to the fact that human actors have bounded rationality and are opportunistic, and to the nature of complex transactions.); Easterbrook & Fischel, *The Corporate Contract*, *supra* note 22, at 34 (arguing that the main role of corporate law is to fill in the gaps in corporate contracts that are the product of the parties' oversight and noting the fact that it is not costless for them to transact).

between shareholders and managers are usually understood as agency contracts[73] or governance structures.[74]

These agency contracts are self-enforcing, according to agency theorists, because the parties—especially managers—are subject to market constraints. Managers who refuse to comply with "the rules of the game" will suffer the consequences: they will not be able to avoid scrutiny because they are repeat players; they will find it difficult to raise capital in the capital markets; their worth in the market for managers will diminish; they will be weeded out through takeovers or proxy fights; and their companies will not survive, but will instead be weeded out by that ultimate weed-whacker—evolution. In the prior subsection, I showed that these market constraints are not very effective.[75] Therefore, relying on market constraints to bolster the viability of implicit agency contracts does not ensure that these contracts will greatly constrain managers.

However, all is not lost. The bargaining theory of the firm helps us focus on the emergence and viability of other informal rules and norms that can help shape shareholder-manager relations. Agency theorists, by focusing on "contracts" and "market constraints"[76] and assuming that these lead to the optimal results, fail to ask many important questions. What happens when there are changes in the effectiveness of different markets? What other informal rules or institutions help constrain managers? How can managers, through their actions, affect the viability of these market constraints and other informal constraints? How do governance structures emerge and change when the "invisible hand" is not the only hand in sight? Bargaining theory helps us answer these questions.[77]

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73 *Cf.* Jensen & Meckling, *supra* note 10, at 311 (The private corporation or firm serves as "a nexus for contracting relationships.").

74 *See* WILLIAMSON, *supra* note 70, at 305 (Shareholders can protect their investment in the firm by adopting governance structures that will "safeguard against expropriation and egregious mismanagement."); Easterbrook & Fischel, *The Corporate Contract*, *supra* note 22, at 1420 ("The first question facing entrepreneurs is what promises to make, and the second is how to induce investors to believe the promises.").

75 The next section deals with the weaknesses of the evolutionary argument. *See infra* notes 78-103 and accompanying text.

76 It is not by accident that agency theorists focus on "contracts" and "market constraints." As explained earlier, the agency theory of the firm developed as a reaction to managerialist theory's claim that managers have virtually unfettered discretion which can only be constrained through legal intervention. Agency theorists want to encourage private ordering to the extent that it is viable. Private ordering, if there are sufficient "market constraints," will produce better results than legal intervention. Therefore, one goal of agency theory is to show that these market constraints are robust. Why the term "contract"? Contract implies consent, which implies legitimacy. *See* Schanze, *supra* note 69, at 468. Thus, Easterbrook and Fischel say that "[v]oluntary arrangements are contracts." EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 14.

77 More importantly, the theory does not by its assumptions foreclose us from asking these questions.

3. *Natural Selection and Efficiency*

Jensen and Meckling's original exposition of the agency theory of the firm presented a static analysis.[78] The relationship between shareholders and managers, however, is dynamic.[79] Shareholders and managers interact in different contexts and over a relatively long period of time; they must adapt to changed circumstances, unforeseen contingencies, and changes in the relative bargaining power of the parties.[80]

Easterbrook and Fischel recognize the dynamic nature of the relationship[81] and provide a theory of how governance structures (agency contracts) evolve over time through natural selection.[82] They argue that competition eliminates practices and institutions that do not assist shareholders.[83] The effects of institutions that have survived for long periods can be more easily gauged by shareholders and managers than by regulators or academics, making the institutions less susceptible to the challenge that there was a "mistake" in the assessment of their costs and benefits (that is, that they are not the optimal institutions).[84] Thus, they conclude that institutions that survive are efficient institutions.[85]

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78 Jensen and Meckling acknowledge that such a static analysis, which they adopted to analyze the equilibrium market outcome of manager-shareholder contracts, fails to take into account the multi-period aspects of shareholder-manager relations. *See* Jensen & Meckling, *supra* note 10, at 351-52.

79 The implicit and explicit contracts between managers and shareholders are highly malleable and subject to negotiation and interpretation. Furthermore, shifts in relative bargaining power between shareholders and managers occur frequently because of changes in industry competition and shareholder concentration. On the structure of shareholdings, see Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155 (1985).

80 In a sense, managers and shareholders interact from the time the corporation is formed until it is dissolved. Even though the individual shareholders and managers may change, not all shareholders can exit the corporation at the same time. *E.g.*, DEL. CODE ANN. tit. 8, § 151(b) (1993) (a corporation is required to have at least one common shareholder, since it must at all times have outstanding at least one class of stock with full voting rights that is not subject to redemption); *id.* §§ 141(a), 142 (a corporation shall be managed by or under the direction of the board of directors, which may in turn delegate some of its responsibilities to managers).

81 *See* EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 14; *see also* Fama & Jensen, *supra* note 31, at 301 ("Our goal is to explain the survival or organizations characterized by separation of 'ownership' and 'control.'").

82 According to Easterbrook and Fischel, mandatory provisions prescribed by law are undesirable because they halt this evolutionary process. *See* EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 31.

83 *Id.* at 13. They cite Alfred Chandler and Oliver Williamson for the argument that "those who do not adapt their corporate governance structure are ground down by competition." *Id.* at 13 (citing ALFRED D. CHANDLER, JR., THE VISIBLE HAND (1977); WILLIAMSON, *supra* note 70).

84 *See id.* at 31.

85 For a critique of this view, see Victor Goldberg, *Relational Exchange: Economics and Complex Contracts*, 23 AM. BEHAVIORAL SCIENTIST 337, 342 (1980) (the view that "[w]hatever is, is right" is incorrect because "[e]fficiency is contextual. Given the social context, the

In essence, agency theorists respond to Berle and Means with a simple riposte: separation of ownership and control is the economically optimal way of organizing the corporation; otherwise, the corporation would not have survived. This argument implies that the formal and informal institutions of corporate governance that have arisen, including the institutions of exit, legal constraints such as fiduciary duties, and implicit and explicit contracts between managers and shareholders, are economically optimal. According to agency theory, the interactions giving rise to these institutions are economically optimal either because they result from voluntary agreements between shareholders and managers[86] or because they are the product of competition in a market for institutions in which only optimal institutions survive.[87] But it is not at all clear that the latter claim is correct. In fact, many other factors affect the survival of institutions.

In analyzing the agency theorists' confidence in the natural selection mechanism, I will focus on three issues: the strength of the competitive process, the time frame involved, and the baseline used. As already discussed in the prior two subsections, market and contractual constraints are not as strong as agency theorists would lead us to believe. Where competitive forces are weak and the discretion of parties is broad, the evolutionary explanation loses a lot of its power.

Even if we were to assume that competitive forces are robust, we need to look at the time frame that the agency theory assumes.[88] A theory that tells us that governance structures will eventually evolve into the optimal institutions[89] does not provide much guidance to parties—shareholders, managers, lawyers, courts, investment bankers, and others involved in current transactions.

A critical move made by agency theorists is in the baseline that they adopt. Neoclassical theory starts with the assumption of perfect information.[90] Agency theory, with its focus on informational problems, rejects using that baseline. Using the neoclassical baseline, according to such theorists, would entail the Nirvana fallacy.[91] So agency theorists adopt a "second best" approach, rejecting the world

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parties will attempt to arrange their affairs as best they can. If the context were different, then the efficient structure would also differ.")

86 *See* JACK KNIGHT, INSTITUTIONS AND SOCIAL CONFLICT 110 (1992).

87 *See* KNIGHT, *supra* note 86, at 115-16; NORTH, *supra* note 68, at 83-84.

88 *See* JOHN MAYNARD KEYNES, A TRACT ON MONETARY REFORM 80 (1923) ("[T]his long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again.") (emphasis omitted).

89 "Firms and teams of managers can compete with each other over the decades to design governance structures . . . ." EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 7.

90 *See* KREPS, *supra* note 33, at 264.

91 *See supra* note 48 and accompanying text.

of perfect information as unreachable and irrelevant.[92] Rejecting the perfect information baseline, however, does not automatically give rise to a commonly acceptable and verifiable baseline.[93]

How does one compare second-best alternatives? Agency theorists tell us that the baseline is "survivability": those institutions that survive are the optimal ones.[94] The justification for using such a baseline is not very strong because the set of "surviving" institutions is itself always changing and evolving, and because there are many variables other than efficiency that determine which institutions survive.

We can better understand the limitations of the survivability baseline by looking more carefully at the nature of institutional change. Examining the effect of institutional change[95] is necessary even if we begin with socially optimal institutions. Over time, the context in which these institutions operate will change, and formerly optimal institutions will lose their optimality.[96] It is usually assumed that new optimal institutions emerge, either through consensual agreements or through the process of natural selection.[97] However, there are a

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92 Agency theorists cannot completely abandon the concept of perfect information or else they would not be able to account for shareholders' ability to determine the magnitude of residual losses associated with agency costs. *See* Dieter Schneider, *Agency Costs and Transaction Costs: Flops in the Principal-Agent-Theory of Financial Markets*, *in* AGENCY THEORY, INFORMATION, AND INCENTIVES, *supra* note 69, at 481, 483.

93 *See* Klaus Spremann, *Agent and Principal*, *in* AGENCY THEORY, INFORMATION, AND INCENTIVES, *supra* note 69, at 3, 8 (Given the malleability of the definition of agency costs, one must "be very careful when using agency costs to compare and evaluate alternative second-best arrangements.").

94 *See* EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 13 ("The history of corporations has been that firms failing to adapt their governance structures are ground under by competition.") (citations omitted); Fama & Jensen, *supra* note 31, at 301 ("Absent fiat, the form of organization that survives in an activity is the one that delivers the product demanded by the customers at the lowest price while covering costs.") (citation omitted).

95 Transaction cost theory shows a better understanding of the role of institutional change than does agency theory. *See* NORTH, *supra* note 68, at 27-35; WILLIAMSON, *supra* note 70, at 20-23.

96 Douglass North provides certain examples of changes in relative prices that would provide the basis for adopting new and more efficient institutions or contracts. These include changes in the ratio of factor prices, the cost of information, and technology. *See* NORTH, *supra* note 68, at 67. Transaction cost theorists, including North, assume that institutional change will occur if the benefits obtained by the parties outweigh the transaction costs (the cost of changing the current institutions or contracts). *Id.* at 67; *see also* WILLIAMSON, *supra* note 70, at 1 (indicating that the main purpose of the economic institutions of capitalism is to economize on transaction costs). The institutional change may also occur due to competitive market forces (i.e., through natural selection). Armen A. Alchian, *Uncertainty, Evolution and Economic Theory*, 58 J. POL. ECON. 211, 213 (1950).

97 *See* NORTH, *supra* note 68, at 83-84; WILLIAMSON, *supra* note 70, at 2 (Economic institutions of capitalism are "numerous, subtle and continuously evolving"; transaction cost analysis focuses on "the comparative costs of planning, adapting, and monitoring task completion under alternative governance structures.") (italics omitted); Fama & Jensen, *supra* note 31, at 301 (examining the survivability of firms that separate ownership and control).

number of reasons why this may not occur: there may be certain hidden benefits to stasis;[98] attempts to change institutions may be restricted by the interests and actions of third parties, such as the state;[99] the parties may lack the knowledge or ability to change the institutions because of uncertainty[100] and bounded rationality;[101] natural selection based on competitive forces may simply not provide a useful paradigm for institutional change;[102] and given the nature of shareholder-manager relationships, the existence of power asymmetries between the parties may lead to institutions or contracts that are not socially optimal.[103]

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98 In other words, institutional rules which at first blush appear to create higher costs may in fact lead to more efficient exchanges. *See* KNIGHT, *supra* note 86, at 112; *see also* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) (Penalty default rules may lead to more efficient outcomes by requiring that a party with an informational advantage reveal information to the other party.).

99 *See* KNIGHT, *supra* note 86, at 112; NORTH, *supra* note 68, at 86-87.

100 *See* KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 55 (1974) (Organizations and their members will make investments by setting up information channels and acquiring skills in information processing and in job-specific areas; these investments involve irreversible capital expenditures.); KNIGHT, *supra* note 86, at 112; RICHARD R. NELSON & SIDNEY G. WINTER, AN EVOLUTIONARY THEORY OF ECONOMIC CHANGE 76-78 (1982) (discussing problem of tacit knowledge and how it affects the transfer of information within organizations, especially information required to "teach" skills to other organizational members).

101 *See* HERBERT A. SIMON, ADMINISTRATIVE BEHAVIOR xxiv (1961) (organizational actors modeled as being "intendedly rational, but only limitedly so") (emphasis omitted); WILLIAMSON, *supra* note 70, at 45-47.

102 Jack Knight argues that focusing on competitive market forces as the selection mechanism that will lead to the emergence of optimal institutions does not make much sense given that "[i]nstitutions are not goods." KNIGHT, *supra* note 86, at 116 (emphasis omitted). While almost anything may be deemed a "good" by economists, "institutions are not tangible, substantive goods." *Id.* This has the following three effects. First, institutions govern and structure the interactions between individuals: thus they "attach to people in ways that substantive goods do not. . . . As long as [particular individuals] remain part of the interaction, [they] remain governed by the rule." *Id.* at 117. The effect is that institutions are not alienable like goods and the party-specific nature of institutions limits the number of competitors. *Id.* Second, because interactions based on institutional rules are not always interchangeable, the identity of the actors may be relevant to the transactions. This may limit the range of alternative transactions. *Id.* Third, the set of possible rules on which institutions can be based is small. The rules, therefore, can be deemed to be "lumpy and coarse-grained" instead of easily fungible. *Id.*; *see also* Mark Granovetter, *Economic Action and Social Structure: The Problem of Embeddedness*, *in* THE SOCIOLOGY OF ECONOMIC LIFE 53 (Mark Granovetter & Richard Swedberg eds., 1992) (discussing institutional embeddedness).

103 This is because power asymmetry prompts the party with superior bargaining power to use that power to guarantee itself a larger slice of the pie, even if it means having a smaller pie to slice (i.e., not adopting the socially optimal institution or contract). *See* KNIGHT, *supra* note 86, at 33-34. Agency theory, as well as transaction cost theory, has relied on the existence of competitive markets in arguing that power asymmetries do not play a large role in shareholder-manager interactions. *See* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 290-91 (180) (constraint from the market for managers); Jensen & Meckling, *supra* note 10, at 328-29 (constraint from market for managers and the capital markets); Henry G. Manne, *Mergers and the Market for Corporate Control*,

C. Evaluating the Agency Theory of the Firm

One can evaluate a theory by the guidance that it provides those who turn to it for counsel. In the case of a theory of the firm, likely repeat customers will be shareholders; managers and directors; other constituencies, such as debtholders and employees; lawyers, accountants, and investment bankers who advise firms; and regulators trying to decide what policies to adopt and how to implement those already adopted. No one theory can satisfy this whole coterie.

For example, there are three basic questions that shareholders of a large public corporation would want answered: (1) How much discretion *should* managers have?; (2) How do we know which managers are the best for the job?; and (3) What should be done about underperforming managers (those who diverge too much from maximizing shareholder wealth)?

Managers and directors want some guidance on how they should act and a sense of how much they can diverge from maximizing shareholder wealth before they bear the consequences (that is, before the gain from so doing is less than the penalty handed out by the shareholders, regulators, or any other party).

Debtholders and employees want to know how to protect their interests and want some guidance on how managers and shareholders are expected to act in situations where manager and/or shareholder interests conflict with theirs. Lawyers, accountants, and investment bankers want information regarding the incentives of the parties involved and information that will allow them to address legal, accounting, and valuation issues. Regulators want to know what policies to adopt and how to carry them out.

The agency theory of the firm provides some guidance to these parties. In particular, as agency theory would suggest, shareholders understand that certain agency costs are unavoidable, that a certain amount of managerial discretion will further their interests, and that managers are subject to certain market and contractual constraints. While this provides some broad guidance, shareholders may want to know what happens when these market and contractual constraints lose some or all of their effectiveness.

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73 J. POL. ECON. 110 (1965) (market for corporate control). On the role of competition in undermining bargaining power, see John Kennan & Robert Wilson, *Bargaining with Private Information*, 31 J. ECON. LIT. 45, 47 n.7 (1993) (some degree of bilateral monopoly is needed to have a bargaining context); *see also* TIBOR SCITOVSKY, WELFARE AND COMPETITION 14 (1971) ("The main curb on a person's bargaining power, and the main pacifying influence on trade in general, is competition. A person has competition if the party he wants to trade with has alternative opportunities of exchange. . . . Competition restricts a person's bargaining power by making the other party less dependent and therefore less keen on striking a bargain with him.").

D. Drawing Boundaries on the Agency Theory of the Firm

If we relax the assumptions of effective market and contractual constraints and of the optimality of existing institutions, we then need to address the following four issues: (1) the degree of managerial discretion in large public firms, (2) the effect of the rise of greater shareholder activism, (3) the willingness of managers to take actions that will benefit shareholders but hurt managers, and (4) the ability of managers and shareholders to come to an understanding that will benefit both sides.[104]

1. *Managerial Discretion and the "Frankenstein Effect"*

Joseph Stiglitz and Aaron Edlin have recently argued that, given the weaknesses of market constraints, "the theoretical puzzle is not so much how to explain the existence of managerial discretion, but to explain the existence of managerial discipline."[105] The level of managerial discretion is important because it affects both present and future interactions between shareholders and managers. For example, managers can use this discretion to compensate themselves more than they would if market constraints were robust.

More importantly, however, managers will use this discretion to put themselves in a better strategic position for future interactions with shareholders. For example, they will take actions that will help them become entrenched or that will affect the amount and accuracy of information available to shareholders in future periods. Managers may also expend company resources to try to change shareholder preferences. Annual reports, proxy statements, and shareholder relations departments are all "legitimate" ways of changing shareholder preferences.[106] The important point is that managerial discretion will be used not only to take away resources from shareholders in the present period, but also to enhance managerial discretion in future periods.

An assumption of the agency theory of the firm is that the principals (the shareholders) will have the power to in some way discipline

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104 These last two are treated together because they are interrelated.

105 STIGLITZ & EDLIN, *supra* note 3, at 3. Stiglitz and Edlin go on to state that "[r]ecent thinking has thus returned to the position of earlier managerial literature which simply took the existence of managerial discretion as an obvious fact and focused on what objectives the managers did in fact pursue." *Id.* at 4. They then indicate that their paper "is a continuation of that tradition." *Id.* at 5. These comments are significant because they are made by economists who have played an important role in developing agency theory.

106 *See* Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291 (N.Y. 1955) (holding that directors may make expenditures from the corporate treasury to influence shareholder preferences during a policy contest).

their agents (the managers).[107] Unlike pure market relationships, in which none of the actors involved have market power, agency relationships are hierarchical relationships in which principals and agents interact as superiors and subordinates rather than as coequal actors.[108]

Thus, in the agency description of the corporation one sees what can be called a "Frankenstein effect": the principals have created the agency relationship, but they have lost most of their ability to discipline their agents and terminate the relationship (other than by selling their shares, which shareholders as a group cannot all do).[109]

Agency theory does not account for the hierarchical reversal[110] implicit in the Frankenstein effect. In such instances, the relationship between shareholders and managers begins to lose its resemblance to such paradigmatic agency relationships as employer-employee, landlord-tenant, and lender-borrower.[111] For example, in these paradigmatic agency relationships, it is usually the case that *before* the agent chooses among possible actions, there is already a contract that specifies the rule for determining the agent's compensation.[112] The issue that arises for principals in these relationships is how to structure these contracts to induce the agents to act in the principals' interest.[113] Furthermore, the principals are in a position to design and impose on their agents a contract with optimal incentive mechanisms.[114]

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107 One can view the agency relationship as a way in which one party, the principal, can "attain and maintain control in order to carry out definite, yet varying purposes." Harrison C. White, *Agency as Control*, *in* PRINCIPALS & AGENTS, *supra* note 18, at 187, 188.

108 *See* LOUIS PUTTERMAN, THE ECONOMIC NATURE OF THE FIRM 6 (1986).

109 *See, e.g.*, DEL. CODE ANN. tit. 8, § 151(b) (1993); *see also* WILLIAMSON, *supra* note 70, at 304-05 (Shareholders as a group are the only constituency of the corporation "whose relation with [it] does not come up for periodic renewal."). Agency theory once again falls back on the other market mechanisms for disciplining. But if these market mechanisms are weak then one needs to explain the effect of these power asymmetries on the relationship of managers and shareholders.

110 Karl Llewellyn in 1930 alluded to such hierarchical reversals in agency relationships:

> Finally, with growing specialization, agency takes on another aspect . . . the specialized . . . purveyor . . . moves largely out of control of his principal, becomes an independent unit and may gather sufficient financial power to finance and even control his scattered "principals" . . . . In all such cases of independence of the "agent" the tendency is strong for the one-time agency to be swallowed up in contract, as between two independent dealers.

Karl N. Llewellyn, *Agency*, *in* 1 ENCYCLOPEDIA OF SOCIAL SCIENCES 483 (1930), *quoted in* White, *supra* note 107, at 188.

111 Fama & Jensen, *supra* note 31, at 308 (separation of roles for managers (initiation and implementation of decisions) and of shareholders who are the risk bearers (ratification of decisions and monitoring of managers)); Stiglitz, *supra* note 39, at 241.

112 *See* Arrow, *supra* note 37, at 37. The fee will depend on the outcome of the agent's actions, as observed by the principal. *Id.*

113 *See* Pratt & Zeckhauser, *supra* note 18, at 2.

114 *See* Pratt & Zeckhauser, *supra* note 18, at 16. Pratt and Zeckhauser admit that this assumption is rarely met in the real world, although they believe that it does not signifi-

As seen above, manager-shareholder contracts differ significantly from the stylized contracts of agency theory. They are usually implicit contracts that do not clearly establish a compensation scheme for managers *ex ante*.[115] Furthermore, the managers and the board of directors determine the nature and content of these contracts.[116] This gives managers certain leeway to engage in strategic behavior.

2. *The Changing Role of Shareholders in Corporate Governance*

Over the last few years, commentators have given increasing attention to the role of shareholders in corporate governance.[117] This new interest has been spurred by the heightened activism of institutional investors. The last decade has seen a great shift in the composition of shareholdings. The Berle and Means corporation, with its thousands of dispersed shareholders, has given way to corporations with shareholdings highly concentrated in the hands of institutional investors. As of the end of 1990, over fifty percent of the equity of public corporations was held by institutional shareholders such as public pension funds, mutual funds, bank trust departments, and private pension funds.[118] Recently, large institutional investors have begun to reinterpret their role in monitoring and disciplining managers and have increasingly challenged managerial autonomy.

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cantly affect the explanatory power of agency theory. *Id.* Benjamin Hermalin, writing about the manager-shareholder agency contract, however, argues that this assumption should be reversed so that it is assumed that it is managers who impose the contract on the principals. *See* Benjamin E. Hermalin, *The Effects of Competition on Executive Behavior*, 23 RAND J. ECON. 350, 351 (1992).

115 *See* Arrow, *supra* note 37, at 49 ("compensation schemes for corporate executives . . . have a large discretionary component"). In fact, managers and the board of directors decide on the compensation scheme at the end of the relevant period. While there may be express compensation contracts in place, such contracts generally leave much discretion for *ex post* determination of compensation. *Id.*

116 In other words, the agents desigu and impose these contracts on the principals, rather than the principals dictating the terms to the agents. *See* Hermalin, *supra* note 114, at 351. This role reversal is generally explained as a function of the collective action problem in shareholder voting. *See supra* note 12.

117 *See infra* part II.C.2.a.

118 *See* Black, *Agents Watching Agents*, *supra* note 13, at 827. The potential for greater shareholder involvement in corporate governance has increased dramatically. Previously, it was inconceivable that shareholders would have considerable bargaining power other than their ability to sell their shares. But the increase in institutional shareholdings brings the bargaining issue into the forefront. As the collective action problem begins to fade, it makes more sense to model the relationship between shareholders and managers as a bargaining game. The key to greater shareholder activism does not lie solely in the ability of shareholders to overcome the collective action problem and certain conflicts of interest faced by money managers. Even if they overcome these two problems, shareholders will have to deal with the fact that they find themselves in a bargaining context in which exit may still prove to be the dominant strategy. Agency theorists writing on the issue of shareholder voting have assumed that it is efficient for shareholders to remain passive, given the existence of other market constraints and the fact that voting is expensive and unlikely to provide high returns. *See, e.g.*, Easterbrook & Fischel, *Voting*, *supra* note 32, at 402-03.

There are two principal reasons for increased shareholder activism: the increased shareholdings by large institutional investors[119] and the growing inefficiencies of the markets for corporate control and managers.[120] In particular, some commentators have explained the rise of shareholder activism as a reaction to the demise of the market for corporate control.[121]

The agency theory of the firm has usually started with the assumption that shareholders have small holdings and are atomistic. Easterbrook and Fischel have argued that, given the collective action problems in shareholder voting, one should not assume that shareholders want to be more involved and want more information; these two assumptions, they claim, "are not supported by evidence."[122] They conclude that shareholders would want to limit the scope of their voting rights and the amount of information that managers are required to supply to them because shareholders are rationally apathetic and are conscious of the cost of producing and disclosing information that they will not want to use in the first place.[123]

This view, of course, cannot explain the rise of shareholder activism. As shareholders move from being rationally apathetic[124] to being more involved in corporate governance, we must modify the theory of the firm to account for this change. The relationships among shareholders and between shareholders and managers will give rise to new forms of strategic behavior for which our theory must account.

3. *The Role of Distributional Conflict*

The main weakness of the agency theory of the firm is its failure to fully account for the distributional conflict between shareholders and managers.[125] This is due to agency theorists' assumption that

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119 Several large public pension funds, such as the California Public Employees Retirement System (CalPERS) and the New York Public Employee Pension Fund, have taken the lead. More recently, private pension funds, such as the Campbell Soup pension fund, have become more involved. *See* Susan Pulliam, *Campbell Soup Fund to Take Activist Role*, WALL ST. J., July 15, 1993, at C1.

120 *See* Coffee, *Liquidity Versus Control*, *supra* note 16, at 1279; Gordon, *supra* note 55, at 347.

121 *See, e.g.*, Gordon, *supra* note 55, at 347.

122 EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 82-83. They go on to say that the disparity between the rhetoric of shareholder democracy and shareholder conduct shows that these assumptions do not hold. *Id.* at 83.

123 *Id.* at 83.

124 Or at best rationally peripatetic (that is, rational shareholders, via the "Wall Street Rule," can also sell their shares when they are dissatisfied with management).

125 Agency theory starts with the premise that shareholders and managers have different interests and that it is precisely managers' attempt to maximize their selfish interests that leads to agency costs. However, the agency costs that agency theory describes are quite limited, especially from a bargaining standpoint, because they do not include strategic bargaining costs. In particular, agency theory unduly minimizes the distributional intentions of managers. For example, managers are seen as having an incentive to incur bond-

shareholders and managers have an incentive to minimize agency costs.[126] This, in turn, allows agency theorists to conclude that shareholders and managers will actually reach an equilibrium contract according to which shareholders incur the optimal amount of monitoring costs and managers bear the optimal amount of bonding costs.[127]

As this Article notes in the next Part, characterizing the relation between shareholders and managers as an ongoing bargaining game allows us to focus on the distributional conflict between them. In the bargaining theory of the firm, managers and shareholders engage in a bargaining game over certain substantive and procedural stakes.[128] The goal of each side is to maximize its share of these stakes.[129] By focusing on this distributional conflict, the bargaining theory of the firm allows us to identify weaknesses within agency theory. Part II will explain the bargaining theory of the firm and explain how this theory addresses the inadequacies of agency theory's underlying assumptions.

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ing costs. However, this is completely true only as long as managers own significant amounts of equity in the corporation. It is only then that they experience the disciplining effect of the capital markets from the discounting of the price of the stock by potential purchasers of the shares. As Jensen and Meckling admit at the end of their article, "[o]ne of the most serious limitation[s] of the analysis is that as it stands we have not worked out in this paper its application to the very large modern corporation whose managers own little or no equity." Jensen & Meckling, *supra* note 10, at 356. Fama and Jensen addressed this issue by focusing on the role of market constraints. *See* Fama & Jensen, *supra* note 31, at 312-15.

126 *See* Jensen, *Organization Theory*, *supra* note 31, at 331; *see also* Pratt & Zeckhauser, *supra* note 18, at 6 (principal and agent have incentives to define monitoring and incentive structures that produce an outcome similar to that which would result if monitoring were costless). Jensen's argument is partially based on the assumption that the organizations that survive market competition will be the ones that minimize agency costs. *See* Fama & Jensen, *supra* note 31, at 302 (the most efficient firm survives); Jensen, *Organization Theory*, *supra* note 31, at 331. This argnment assumes that the market constraints upon which Jensen relies are robust and that information regarding the level of agency costs is easily disseminated. For a further critique of the evolutionary theory, see *supra* notes 94-104 and accompanying text. *See also* KNIGHT, *supra* note 86, at 96-108.

127 *See* Butler, *supra* note 32, at 110 ("[M]anagers select the least cost manner of controlling agency costs."); Jensen & Meckling, *supra* note 10, at 328.

128 For a discussion of these substantive and procedural stakes, see *infra* notes 137-41 and accompanying text.

129 In essence, agency theory fails to take into account the role of distributive conflict in undermining the optimality and stability of agency contracts. The agency costs must be factored into a wider bargaining context. Doing so demonstrates that the optimal contracts advanced by agency theory provide a distorted view of shareholder-manager relations. Furthermore, the stability of these contracts is thrown into question when one factors in this ongoing distributive conflict. This is particularly true with the contracts of shareholder-manager relationships, most of which are implicit and not subject to third-party enforcement.

II
A Bargaining Theory of the Firm

I have argued above that agency theory does not provide a complete and coherent theory of shareholder-manager relations.[130] In this Part, I argue that these relations can be better explained if modeled as an ongoing bargaining game between managers and shareholders. Bargaining theory addresses the weaknesses of agency theory and managerialist theory by focusing more intently on several factors: the strategic behavior of managers and shareholders; the bargaining costs produced by such strategic behavior; the dynamic, ongoing nature of stockholder-manager relationships; the role of managerial discretion and informational asymmetries; and the issue of institutional emergence and change.

A bargaining context exists when two or more parties negotiate over the possibility of undertaking some cooperative venture.[131] Osborne and Rubenstein have described the typical bargaining problem as one in which "(i) individuals . . . have the possibility of concluding a mutually beneficial agreement, (ii) there is a conflict of interests about which agreement to conclude, and (iii) no agreement may be imposed on any individual without his approval."[132]

These criteria are met in the shareholder-manager context. First, shareholders and managers can create a bargaining surplus by cooperating and coordinating their actions.[133] Second, because there is more than one way of structuring an agreement to cooperate and be-

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130 In particular, agency theory fails to fully account for the weakness of market and contractual constraints, the existence of managerial discretion, and the effect of the distributional conflict that pervades the shareholder-manager relationship. *See supra* part I.B.

131 *See* Harsanyi, *supra* note 24, at 54; Nash, *supra* note 24, at 155.

As Robert Cooter has pointed out, the key to a bargaining game is that the production of the surplus is contingent on the ability of the parties to reach an agreement on distribution. Robert Cooter, *The Cost of Coase*, 11 J. Legal Stud. 1, 17 (1982); *see also* Steven J. Brams, Negotiation Games: Applying Game Theory to Bargaining and Arbitration 29 (1990) ("The *bargaining problem* concerns how to get players in a conflict to reach an agreement that is in their mutual interest when it is in each player's individual interest to hold out for as favorable a settlement as possible."). *See generally* Thomas C. Schelling, The Strategy of Conflict (1960) (classic account of bargaining and coordination games). A bargaining game will involve a series of offers and counteroffers by the parties, with each trying to convince the other that it is committed to acting in a certain way.

132 Osborne & Rubenstein, *supra* note 25, at 1.

133 Shareholders and managers interact on an ongoing basis in a number of contexts, including (1) regular corporate interactions, such as election of directors, dissemination of information to shareholders, and decisions on payment of dividends and the compensation of managers; (2) non-regular governance transactions, such as voting on antitakeover amendments and other types of non-regular resolutions; and (3) extraordinary transactions, such as mergers and dispositions of substantial amounts of assets. By cooperating in these interactions, shareholders and managers can produce a surplus. For a discussion of the mechanisms used in bargaining, see *infra* part II.C.

cause different agreements yield different distributional outcomes,[134] managers and shareholders will have a conflict of interest[135] over which agreement to reach. In other words, individual interests conflict with the collective interest in reaching a bargain as quickly and as cheaply as possible.[136] Finally, no agreement may be forced on either party, given that each party can choose to exit the corporation.

A. The Stakes: Substantive and Procedural

We must first get a better idea about the stakes over which shareholders and managers bargain. I divide the stakes into two categories: substantive stakes and procedural stakes.

1. *Substantive Stakes*

The substantive stakes are what I shall call the "net organizational revenues." These are the revenues of the firm after all fixed claimants are paid. For example, think of a firm with one shareholder, one manager, two nonmanagement employees, and a ten-year bank loan. At the end of year one, the firm will have produced a certain total

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134 Gains to shareholders arising from the adoption of stricter governance mechanisms often come at the expense of managers. Rational managers would want to prevent shareholders from imposing stricter governance mechanisms. For example, if the board of directors is voted out of office or if managers lose a vote to adopt a poison pill, shareholders are better off and managers are worse off. If, on the other hand, shareholders lose on both issues, then managers are better off and shareholders are worse off. *See generally* 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) [hereinafter Easterbrook & Fischel, *The Proper Role*] (arguing that allowing management to use defensive tactics in the face of a tender offer diminishes shareholder welfare); Eugene Furtado & Vijay Karan, *Causes, Consequences, and the Shareholder Wealth Effects of Management Turnover: A Review of the Empirical Evidence*, 19 FIN. MGMT. 60 (1990).

135 Thomas Schelling's classic book on bargaining is in fact a study of "the strategy of conflict." SCHELLING, *supra* note 131. Schelling begins with the assumption that "most conflict situations are essentially *bargaining* situations. They are situations in which the ability of one participant to gain his ends is dependent to an important degree on the choices or decisions that the other participants will make." *Id.* at 5. As Schelling points out, a bargaining game is a game of strategy, in which there is an interdependence in the decisionmaking process and in which the best course of action for each player depends on how the other players will act. *Id.* at 1 n.1.

136 Analyzing the causes of bargaining breakdown is important when the parties have incomplete information, as they do in the shareholder-manager context. Surprisingly, traditional bargaining models have by and large avoided the issue of bargaining breakdown by assuming that an efficient settlement will be reached. *See* V. P. Crawford, *A Theory of Disagreements in Bargaining*, *in* THE ECONOMICS OF BARGAINING 122 (Ken Binmore & Partha Dasgupta eds., 1987). In addition to Crawford's piece, numerous recent articles have dealt with the issue of bargaining breakdown. *See e.g.*, Kalyan Chatterjee, *Disagreement in Bargaining: Models with Incomplete Information*, *in* GAME THEORETIC MODELS OF BARGAINING 9 (1985) (discussing recent models of two-player bargaining with incomplete information); Cooter, *supra* note 131 (analyzing Coase's concrete examples); Robert Cooter & Stephen Marks, *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225 (1982) (discussing pretrial bargaining and settlement); Kennan & Wilson, *supra* note 103 (examining the role of information in bargaining).

amount of revenue, *R.* From this total revenue we need to subtract the cost of producing the output being sold, *C,* including the cost of raw materials and the wages of the two nonmanagement employees, and the principal amount and interest due to the bank on the ten year loan, *P.* Thus, the net organizational revenue is R - (C + P).

This net organizational revenue will be split between the manager and the shareholder. For example, the manager will be paid compensation and the shareholder will receive dividends and retained earnings.[137] Shareholders benefit from retained earnings when the firm reinvests them in projects with positive net present values, which in turn is reflected in share price. The shareholder and manager will bargain over how much compensation[138] the manager will receive and the value of the dividends the shareholder will receive. These stakes are the net organizational revenues. If both parties could agree how to divide the stakes at zero cost, then the whole surplus would be preserved. Each party, however, will try to maximize her share of the stakes, which will lead to partial or complete dissipation of the surplus.

2. *Procedural Stakes*

A number of constraints affect the shareholder-manager bargaining environment, including laws, informal institutional rules, and market mechanisms. The adoption of a particular institutional rule may benefit one party at the expense of the other, and because shareholders and managers are repeat players, they will have an interest in shaping these institutional constraints so as to affect future bargaining interactions. The bargaining interactions that contribute to the emergence and shaping of these constraints is what I call bargaining over "procedural stakes."[139]

In the shareholder-manager context, these procedural stakes include the following issues: the adoption of antitakeover devices; changes in state antitakeover laws; changes in the proxy rules; requirements of increased disclosure of management compensation; changes in the capital structure; investment decisions to increase the value of

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137 *See* Stephen A. Ross & Randolph W. Westerfield, Corporate Finance 13-16 (2d ed. 1988).

138 This compensation can be direct or indirect. Shirking (i.e., not working as hard as they would in a business they owned) and nonmonetary perquisites are means by which managers take their cut of net revenues hefore the revenues are generated. *See* Jensen & Meckling, *supra* note 10, at 312-13.

139 The history of shareholder-manager relations over the last 30 years, including concerns about the voting mechanism, the race to the bottom, composition of the board, management compensation, manager resistance to takeovers (including opposing actual takeovers, adopting antitakeover devices, and lobbying for anti-takeover statutes), and, more recently, manager opposition to cbanging the proxy rules, illustrates the persistence of this strategic behavior over these procedural stakes.

the current management team, as well as other attempts at entrenchment; attempts by managers to change the preferences of shareholders;[140] and attempts by managers to change the perceptions of the board of directors, the company's independent accountants, regulators, industry analysts, and financial intermediaries. Managers often spend company resources pursuing these goals. With the increase in institutional investor activism, one can expect that shareholders will increase their bargaining over procedural stakes.[141]

B. Why Shareholders and Managers Bargain: Managerial Discretion and Informational Asymmetries

The existence of managerial discretion and informational asymmetries leads to strategic behavior and bargaining by managers and shareholders.[142] Once we take full account of managerial discretion and informational asymmetries, we will be able to cast some doubt on the conclusion that managers have an incentive to minimize agency costs and act "as if they have shareholders' interest at heart."[143]

1. *Why Bargain?*

Shareholders have recently become more involved in corporate governance issues,[144] including negotiating directly with managers.[145] In the next section, I discuss more fully the mechanics of bargaining by shareholders, but for now I focus on why shareholders and managers would want to bargain. The simple answer, of course, is that these parties believe that they can gain something from bargaining. In a world of perfect competition there would be no room for bargaining.[146] As we have seen, however, this is not the world inhabited by shareholders and managers—in their world of managerial discretion and informational asymmetries, there is plenty of room for bargaining.

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140 Annual reports, proxy statements, and shareholder relations departments are all "legitimate" ways for managers to change shareholder preferences. They can be seen as part of one big advertisement campaign on behalf of management policy. Many managers are in the business of trying to influence consumer preferences to get them to buy the company's product; it should not be surprising that managers would use similar strategies to sell the product that they value the most—themselves.

141 For example, trying to change the composition of boards, increase disclosure requirements for managers, and change the proxy rules. *Cf.* Black, *Shareholder Passivity*, *supra* note 13, at 570-75 (discussing specific examples of institutional shareholder activism).

142 This result is due to the weakness, addressed above, of the market, contractual, and evolutionary constraints on which agency theory relies. For a discussion of problems with these assumptions, see *supra* notes 49-104 and accompanying text.

143 Butler, *supra* note 32, at 122 (emphasis omitted).

144 For a more detailed discussion, see *supra* notes 20, 118-21 and *infra* notes 163-68 and accompanying text.

145 *See infra* notes 163-70 and accompanying text.

146 *See* Kennan & Wilson, *supra* note 103, at 47 n.7.

Our initial answer can now be expanded: shareholders and managers bargain because they believe that they can increase the size of their slice of the corporate pie through bargaining.[147] The operative word here is *believe.* The parties are involved in a game[148] in which their beliefs are shaped through interactions with each other. Because of bounded rationality[149] and other informational problems, parties will often find it difficult to value the true costs of their strategic behavior. This is particularly true in the corporate context, in which the results (and thus the penalties) of a party's decision to take the "wrong" action may not be immediately apparent and may be affected by numerous factórs, not all of which can be identified or verified. As a result, the equilibrium outcome may be random, so that the same decision will sometimes benefit and sometimes hurt the party.[150] The existence of managerial discretion and informational asymmetries, which I analyze in the next section, encourages bargaining and exacerbates the problems I have just discussed.

2. *The Effect of Managerial Discretion*

Managerialists argue that managers have virtually unfettered discretion. The way to maximize shareholder wealth, they believe, is by limiting such discretion—a job that they assign to courts and legisla-

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147 The net return to managers can increase if their actions lead to an increase in the size of the corporate pie. More importantly, however, their net return may in certain cases increase even if the pie remains the same or becomes smaller. The latter scenario would occur if the managers could capture a share of the bargaining surplus exceeding the net losses associated with their strategic behavior.

148 A "game" for this purpose is defined as

> a situation in which the actions of one person perceptibly affect the welfare of another or vice versa. . . . [T]he hasic method of game theory is to argue that individuals try to predict what others will do in reply to their own actions, and then optimize on the understanding that others are thinking in the same way.

SHAUN H. HEAP ET AL., THE THEORY OF CHOICE 94 (1992).

149 For discussion of bounded rationality, see I HERBERT A. SIMON, MODELS OF THOUGHT 3 (1979). Simon states:

> The point of departure is the observation that human thinking powers are very modest when compared with the complexities of the environments in which human heings live. If computational powers were unlimited, a person would simply consult his or her preferences (utility functions) and choose the course of action that would yield maximum utility under the given circumstances. That is, of course, just what the "rational man" of classical economic theory does. But real human beings of bounded rationality . . . must be content to satisfice—to find "good enough" solutions to their problems.

Id.; WILLIAMSON, *supra* note 70, at 45-46.

150 For a further discussion of this issue, see *infra* notes 226-27 and accompanying text. Of course, one role of informal and formal institutions—*e.g.*, conventions, hahits, and laws—is to bring some certainty to these interactions. *See* KNIGHT, *supra* note 86, at 22-25; DAVID LEWIS, CONVENTION: A PHILOSOPHICAL STUDY (1969); EDNA ULLMANN-MARGALIT, THE EMERGENCE OF NORMS (1977).

tors.[151] Agency theorists admit the existence of some managerial discretion but argue that what we see is the best that we can get.[152]

Bargaining theory argues that the amount of managerial discretion is more akin to that described by managerialists but argues that both markets and rules—formal (legal) rules and informal (institutional) rules—are the source of any potential alignment of managerial and shareholder interests. It concludes that to better understand how that alignment occurs and the role played by strategic behavior, we must focus on the bargaining nature of the relationship. In other words, what we see is *not necessarily* the best that we can get.

Bargaining theory begins with the principle that the economic rewards of managers are not all contractually determined or the product of an "invisible hand." In fact, such rewards are influenced by a numbers of factors, including (1) the performance of the company, (2) informational asymmetries, (3) the interaction between shareholders and managers (in the proxy context among others), (4) the efforts of managers (including their effort in acquiring company-specific information and knowledge), and (5) exogenous factors.[153] As a result, managers and shareholders bargain over certain substantive stakes—the net organizational revenues. At the end of each period, when the managers slice the corporate pie, they will neither be completely constrained by markets and contracts nor be completely free from such constraints. The strength of the constraints for each particular period is the subject of bargaining between shareholders and managers.

Agency theorists, on the other hand, "designate" shareholders as the sole residual owners of the corporation.[154] This means that shareholders will be entitled to the revenues remaining after all other contractual claimants of the firm are paid.[155] However, naming shareholders the "sole residual owners" may prove to be just that—a

151 *See supra* notes 3-8 and accompanying text.

152 *See supra* notes 10-13 and accompanying text for discussion of the "Nirvana fallacy."

153 These are somewhat analogous to those set forth by Masahiko Aoki when discussing shareholder-labor bargaining. *See* MASAHIKO AOKI, INFORMATION, INCENTIVES, AND BARGAINING IN THE JAPANESE ECONOMY 154-55 (1988) [hereinafter AOKI, INFORMATION].

154 While we may desire such a result as a normative goal, it does not follow that it describes the current state of the world. Given the level of managerial discretion, it is inaccurate to conclude that managers are not residual holders. Some theorists have argued that non-management employees of the firm are residual claimants who bargain with the other residual claimants, the shareholders, over the residuals of the corporation. *See* AOKI, CO-OPERATIVE GAME THEORY, *supra* note 17, at 61-62; AOKI, INFORMATION, *supra* note 153, at 154-55.

155 *See* EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 24-25; Fama, *supra* note 31, at 290. In the nexus of contract theory, these fixed-claim claimants include managers, labor, debtholders, etc. (everyhody except the shareholders).

name—in a world of substantial managerial discretion, in which contractual and market constraints are weak.[156]

3. *The Effect of Informational Asymmetries*

In order to understand the role of managerial discretion in shareholder-manager bargaining, we must understand the role played by informational asymmetries. The relationship between shareholders and managers is filled with informational asymmetries. Because managers run the day-to-day affairs of the corporation, they have greater access to and control over information regarding the prospects of the enterprise, the level of managerial effort, and the results of their prior actions and decisions. Managers also enjoy greater control over the creation, memorialization, and dissemination of information. These informational asymmetries increase the discretion of managers and affect the ability of shareholders to monitor and discipline them.

For example, the managers of a large public corporation have informational advantages in several different scenarios. They have better access to information of the following types: information regarding the firm's performance, including information about market conditions, new or potential competitors, the loss of key customers, the growing dissatisfaction or impending bankruptcy of such customers, and so on; information regarding how hard the managers and their colleagues are working, how competent or incompetent they are, and the personal ties among those in the managerial ranks; and information regarding how carefully managers make decisions regarding investments, the disposition of assets, product development, and the expansion of markets. When a decision leads to a negative outcome (for example, when managers make a bad investment decision), managers have an informational advantage in evaluating these decisions after the fact. Managers will have an incentive to blame such negative results on extraneous, unexpected events.

In the end, shareholders have to rely (to a great degree) on the information that managers reveal to them, whether managers do so voluntarily or under legal obligation. Not all relevant information will be revealed to shareholders, and the veracity of that which is released cannot be completely verified.[157] Thus, as a result of managerial dis-

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156 Viewing shareholders as the sole residual claimants does not make sense unless one of two things is shown: (1) that the economic rewards to the fixed claimants are all contractually determined *ex ante* or (2) that there are certain market constraints that do not allow these other claimants to try to bargain for a share of the residuals. *See* AOKI, CO-OPERATIVE GAME THEORY, *supra* note 17; AOKI, INFORMATION, supra note 153, at 150-51 (for point (1)); Kennan & Wilson, *supra* note 103, at 47 n.7 (for point (2)).

157 For discussion of the pros and cons of requiring managers to disclose more information, see Basic Inc. v. Levinson, 485 U.S. 224, 230-31 (1988); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 448-50 (1976).

cretion and informational asymmetries, the economic rewards to managers and shareholders are not determined contractually, *ex ante.* This allows for a bargaining region to exist and thus leads to bargaining between shareholders and managers over the division of the corporate pie.

C. The Mechanics of Bargaining

In this subpart, I focus on the mechanics of shareholder-manager bargaining. First I discuss the nature of managerial bargaining and then examine shareholder bargaining (that is, how shareholders can be said to be involved in a bargaining game). Shareholder bargaining is discussed within two distinct historical periods: bargaining during the era of institutional investor activism, and bargaining before institutional investor activism. I then discuss bargaining asymmetries that arise, and conclude by examining inefficiencies arising out of the bargaining interaction.

1. *The Nature of Managerial Bargaining*

It is easy to conceptualize managers as being involved in a bargaining context, given that the group of managers is much smaller than that of shareholders. As we have seen, managers control corporate assets, corporate-specific information, investment decisions, decisions regarding the capital structure of the firm, and the firm's dividend policy. Thus, managers have the opportunity (and incentive) to engage in strategic behavior vis-à-vis shareholders. As a result, almost all management decisions can be seen as part of a bargaining game in which managers are either determining the current division of the corporate pie or positioning themselves to obtain a bigger slice of the pie in the future.[158]

2. *The Nature of Shareholder Bargaining*

Shareholders, however, are part of a larger and less homogeneous group. Furthermore, they are subject to the collective action problems discussed above.[159] As a result, we need to justify the proposition that shareholders actually bargain. In analyzing the mechanics

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158 Managers will behave strategically at t=1 so that they can gain a bargaining advantage at t=2. This behavior may include creating or changing institutions, changing the capital structure, or making investment decisions so as to make themselves indispensable in the future. *See* STIGLITZ & EDLIN, *supra* note 3, at 5 (arguing that managers make investment decisions so as to entrench themselves by making it more costly to replace them in the future); *see also* Andrei Schleifer & Robert W. Vishny, *Management Entrenchment: The Case of Manager-Specific Investments*, 25 J. FIN. ECON. 123 (1989) (managers entrench themselves by making manager-specific investments that make it costly for shareholders to replace them).

159 *See supra* notes 12-13 and accompanying text.

of shareholder bargaining, it is useful to look at two different periods of shareholder bargaining. The first is the period prior to the mid-to-late 1980s, before institutional investors became earnestly involved in corporate governance issues.[160] The second is the period from the mid-to-late 1980s to the present, when institutional investor activism began to take hold.[161]

Bargaining requires some sort of communication, whether explicit or implicit, between the parties.[162] Shareholders bargain with managers through both explicit and implicit communication. There is no need for actual negotiations in the normal sense of the word. Instead, what is needed is a realization that cooperation can bring the parties greater gains than they would realize working alone. Through ongoing interactions and explicit or implicit acts, the parties will eventually either agree to cooperate or fail to reach such an agreement. Having this model in mind, I will look at how shareholders currently bargain, given the growth in shareholder activism in the last few years. I will then look at how they can be deemed to be bargaining implicitly, even if we assume a world of little direct shareholder activism.

a. *Bargaining in the Era of Institutional Investor Activism*

Shareholder activists have begun to make their own governance proposals, to oppose managers' proposals and managers' slates of directors, and to negotiate directly with management and outside directors. Some institutional investors, such as the California Public Employees Retirement System (CalPERS), have taken a very active role in directly negotiating with management and board members.[163]

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160 *See* Black, *Shareholder Passivity*, *supra* note 13, at 526-29.

161 As we will see, this division is somewhat artificial, since all that has changed from one period to the other is the amount of explicit bargaining being carried out by shareholders, through their institutional investor "representatives."

162 As Schelling points out:

> The bargaining may be explicit, as when one offers a concession; or it may be by tacit maneuver, as when one occupies or evacuates strategic territory. It may, as in the ordinary haggling of the market-place, take the *status quo* as its zero point and seek arrangements that yield positive gains to both sides; or it may involve threats of damage, including mutual damage, as in a strike, boycott, or price war, or in extortion.

SCHELLING, *supra* note 131, at 5.

163 *See* Susan Pullman, *Calpers Goes Over CEOs' Heads in Its Quest for Higher Returns*, WALL ST. J., Jan. 22, 1993, at C1 (CalPERS begins to negotiate directly with board members and with management in companies such as General Motors, Westinghouse Electric, Advanced Micro Devices, Boise Cascade, Champion International and Sizzler International). Dale Hanson, the head of CalPERS, has said "that [CalPERS'] objective is dialogue, dialogue" and has proceeded to negotiate directly on behalf of other shareholders. *See* George Anders, *While Head of Calpers Lectures other Firms, His Own Board Frets*, WALL ST. J., Jan. 29, 1993, at 1; *see also* Johnnie L. Roberts, *Time Warner Asks Big Shareholder For Board Advice*, WALL ST. J., Jan. 21, 1993, at B6. The degree of activism is indicated by the following comments attributed to Dale Hanson, chief executive officer of CalPERS:

Institutional investors have also begun to adopt active investment strategies aimed at directly influencing managers' decisions.[164]

Institutional investors are thereby acting as representatives for other shareholders in bargaining with managers and board members. This increased level of explicit bargaining raises several questions. When should we encourage such representation by institutional investors? In other words, when do we want to encourage bargaining? When would bargaining be inefficient? What institutions have arisen or may arise to deal with this increased bargaining? How quickly will the current institutions, such as that of "exit," change under these new circumstances?[165]

Let us now look at an example of the mechanics of bargaining by institutional investors. In the 1991 proxy season, CalPERS announced that it would no longer make shareholder proposals but would instead attempt to negotiate directly with the management of companies in its portfolio that were underperforming. CalPERS, however, did not meet with much success in its quest to have management negotiate and eventually returned to its policy of making shareholder proposals to supplement its continued attempts to influence managers and board members through independent negotiations. Some commentators believe that these types of informal negotiations will prove to be the most useful.[166]

> As a case in point, Mr. Hanson cited ITT Corp. "Relationship investing is being able to say to Howard Aibel [ITT's executive vice president and chief legal counsel]: 'Congratulations. Your stock hit $83,'" Mr. Hanson said. "We began our conversations [with ITT management] about $45 ago."

Joseph P. White, *Calpers Activist Chief Wants to Take Larger Holdings in Fewer Companies*, WALL ST. J., May 7, 1993, at A12.

164 *See* Lilli A. Gordon & John Pound, Active Investing in the U.S. Equity Markets: Past Performance and Future Prospects (1993) (report prepared for CalPERS, Jan. 11, 1993) (on file with author). According to Gordon and Pound, active strategies

> typically involve exerting significant influence over corporate policy or control over the corporate entity in the hope of elevating the value of the firm. An active investment strategy is thus one in which the returns derived from a given investment are endogenous—subject to influence by the individual investor after the investment is made. In economic terms, an active investor views [herself] as having market power, namely, the power to affect the outcome of an investment strategy by virtue of direct actions that . . . she undertakes.

Id. at 9.

165 Questions like this one are best addressed through a bargaining theory of the firm. However, such questions are outside the scope of this Article.

166 *See* Black, *Agents Watching Agents*, *supra* note 13, at 847 ("Much of the value of institutional oversight will come through informal manager response to the wishes of large shareholders and through negotiated compromises."). While Black recognizes that negotiations without a credible threat will fail (as they in fact did), he does not focus on the true strategic nature of the shareholder-manager relationship. *Id.* at 848. In fact, he has a very optimistic view about the way managers will behave in reaction to increased shareholder involvement, which fails to fully take into account the distributive conflict involved. *See id.* at 848-49.

We can better evaluate why CalPERS' negotiation posture met with failure and assess the viability of these informal negotiations in the future by focusing on the issue of bargaining power. CalPERS' strategy of not making shareholder proposals and relying solely on negotiations failed because CalPERS could not make a credible threat to force managers to negotiate. As I have argued, managers will bargain over redistributing corporate income (the "substantive stakes") only if they have no other choice. We cannot rely on the benevolence of managers, as some commentators seem to do.[167] Furthermore, we cannot rely on the assumption that shareholders, as principals, can somehow force managers to act in the best interest of shareholders. Such a view does not consider the Frankenstein effect discussed above.[168]

This does not mean, however, that such direct bargaining between shareholders and managers will not be successful in the future.[169] What it does mean is that one needs to consider the distributive conflict involved and how the bargaining power of the parties will influence the bargaining outcome.

b. *Bargaining Before Institutional Investor Activism*

Shareholders want to maximize the amount of the substantive and procedural stakes that they receive when the corporate pie is divided. Managers have the same interest in maximizing their slice of the pie. Each party behaves strategically to achieve its goal. It is usually assumed that shareholders are not involved in bargaining with managers because they are a dispersed group of individuals who would rather not become involved in corporate governance because of collective action problems. I will argue, however, that shareholders are involved in both explicit and implicit bargaining with managers. Shareholders sometimes bargain through representatives, or èntrepreneurs[170] who act notwithstanding the collective action problem. Shareholders also bargain individually even when there are no representatives or entrepreneurs involved.

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167 *See, e.g., id.* at 847-48; Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 905 (1991).

168 *See supra* part I.D.1. In other words, in the shareholder-manager context, "your servant is your master." THE POLICE, *Wrapped Around Your Finger*, *on* SYNCHRONICITY (A&M Records 1983).

169 In fact, CalPERS has met with more success recently, after jettisoning its no shareholder proposal policy. *See* George Anders, *While Head of Calpers Lectures Other Firms, His Own Board Frets*, WALL ST. J., Jan. 29, 1993, at A9.

170 *See* TERRY M. MOE, THE ORGANIZATION OF INTERESTS: INCENTIVES AND THE INTERNAL DYNAMICS OF POLITICAL INTEREST GROUPS 36-37 (1980) (describing the "political entrepreneur").

i. *Bargaining through representatives*

Shareholders bargain with managers through representatives. The most obvious example is the board of directors. The board can be characterized as a representative of shareholders insofar as it negotiates with managers over compensation, investment decisions, and many other decisions that require board approval.[171] The board, of course, is not a perfect representative of shareholders. Board members are usually nominated, and, in many cases, are co-opted by managers.[172] Nevertheless, boards have proven to be useful bargaining agents for shareholders during extraordinary situations, such as takeovers and severe business downturns.[173]

Shareholders who bring derivative suits act as representatives for other shareholders in bargaining with managers. Derivative suits allow shareholders to become directly involved in a past or future decision or action by management on behalf of the corporation. Shareholders traditionally have not been involved in such direct action because corporation law requires that they rely on the board as their representative in dealing with management.[174]

The proxy system is another venue through which one or more shareholders can act as representatives of other shareholders in bargaining with management. By significantly increasing their voting power, the representatives can bargain over substantive issues or the composition of the board of directors (and thus, indirectly, over the composition of management).

In each of the circumstances noted above, shareholders directly or indirectly communicate to managers certain preferences and make certain threats. Managers react to these preferences and threats by ascertaining the expected actions of shareholders and devising a bargaining strategy accordingly. For example, managers may give in to the board on a policy matter, they may fight a derivative suit or opt for

171 *Cf.* DEL. CODE ANN. tit. 8, § 141(a) (1993) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . .").

172 *See* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS., Summer 1985, at 83; Charles W. Murdock, *Corporate Governance—The Role of Special Litigation Committees*, 68 WASH. L. REV. 79, 102-16 (1993) (analyzing "structural bias" of special litigation committees).

173 Recent examples include the resignations of top executives at American Express, Westinghouse Electric, and Eastman Kodak, precipitated by Board action. *See Corporate Chiefs Polish their Relations with Director*, WALL ST. J., Oct. 15, 1993, at B1, B9.

174 The demand requirement in derivative suits is a way of distingnishing those cases in which the board is so tainted that it cannot be trusted to act as the representative of the shareholders. For a discussion of the rationale behind the demand requirement and of the circumstances in which demand will be excused due to Board conflict of interest, see generally Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

a settlement, they may resist shareholder proposals, or they may implement the suggested policy changes.

ii. *Bargaining by individual shareholders and the emergence of institutions*

Shareholders do not bargain solely through representatives or entrepreneurs. Each individual shareholder is also involved in a bargaining game with managers. This bargaining is of the implicit, tacit kind analyzed by Schelling.[175] Implicit bargaining is made possible by indirect forms of communication. A shareholder is interested in maximizing the size of the slice she receives from the corporate pie and therefore is interested in communicating her preferences and threats to managers. In most cases, it is too costly for individual shareholders to communicate explicitly with managers. However, both managers and shareholders realize that their best course of action depends on what the other party will do. For example, the threat of a derivative suit, a proxy battle, selling of shares, or withholding future capital affects management's bargaining power. Exiting the corporation or threatening exit is a tacit bargaining technique used by individual shareholders.[176] Such threats constrain managers because they create a risk that shareholders will discipline them.[177]

Viewing individual shareholders as being involved in a bargaining game with managers is important because it allows us to explain the emergence of certain institutions affecting shareholder-manager relations. These institutions suggest the existence of a bargaining relationship in which one party, management, has traditionally enjoyed a great deal of bargaining power. Following Jack Knight, I will argue that formal and informal institutions and rules relating to shareholder-manager relations are a product of the strategic behavior of shareholders and managers seeking as large a slice of the corporate

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175 *See* SCHELLING, *supra* note 131, at 5.

176 Of course, the larger a shareholder's holding, the greater her bargaining power. Some commentators would remove the individual shareholder from the equation and argue that managers are only bargaining against an abstract entity; that is, the market. *See* EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 23-24. This is not a very informative analysis of a context shaped by individual preferences, all of which are not necessarily homogeneous. For a discussion of heterogeneous expectations, see, e.g., Robert Jarrow, *Heterogeneous Expectations, Restrictions on Short Sales, and Equilibrium Asset Prices*, 35 J. FIN. 1105 (1980); Joram Mayshar, *On Divergence of Opinion and Imperfections in Capital Markets*, 73 AMER. ECON. REV. 114 (1983); Edward M. Miller, *Risk, Uncertainty, and Divergency of Opinion*, 32 J. FIN. 1151 (1977).

177 Without the threat of shareholder action, we would expect managers to take at least as big a slice of the corporate pie as fiduciary duties would allow. Of course, the enforcement of fiduciary duties depends in turn upon shareholder action (i.e., bringing derivative suits).

pie as possible.[178] To achieve this distributive goal, managers will try to force shareholders to take actions they would not otherwise take.[179] Managers use informational advantages and control over the assets and resources of the corporation to affect the way shareholders act. For example, the managers may force a shareholder to use the exit option rather than the voice option. In time, individual shareholders learn what to expect from managers and act accordingly.[180] This learning and adaptation process leads to the emergence of institutions that govern not only the actions of individual shareholders, but also how shareholders act as a group.[181]

Some agency theorists conclude that the institution of exit[182] is the optimal institution.[183] They reach this conclusion on the basis

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178 Jack Knight provides a bargaining theory of social institutions. He argues that social institutions and rules arise out of a process of strategic conflict in which actors vie for distributional advantages. *See* KNIGHT, *supra* note 86, at 126. Frequently, these actors have the potential to reach a mutually beneficial agreement, but come into conflict about how to divide the bargaining surplus. Thus, they will adopt certain rules and institutions to structure their interdependent activities and reach an equilibrium outcome in their bargaining. These institutions will constrain strategic action and help achieve a bargaining settlement. However, since more than one set of institutions or rules can be chosen, the parties may disagree about which ones to adopt. The party with superior resources and bargaining power will be able to force other parties "to act in ways contrary to their unconstrained preferences." *Id.* at 127 (emphasis omitted). Thus, Knight concludes that actors respect both formal and informal rules "not because they have agreed to them and not because they evolved as Pareto improvements but simply because they cannot do better than to do so." *Id.* (emphasis omitted).

179 Thus, while an unconstrained shareholder would prefer to remove a manager who is acting against her interest, she will instead opt for the "exit" strategy, given management's greater bargaining power. On the exit-voice distinction, see ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY 36-43 (1970).

180 After awhile, shareholders will recoguize the power asymmetries involved in their relationship with managers. As Knight explains, in connection with the emergence of social institutions generally:

> The interesting problem relates to the generalization of self-enforcing rules through a decentralized emergence process: how commitments established in individual interactions come to be recognized and respected as the accepted rule of action for the society as a whole. An answer can be found in the ability of strategic actors to recognize those asymmetries in power that support those commitments.

KNIGHT, *supra* note 86, at 140.

181 Important in the emergence of these institutions is the existence of frequent and repeated interactions among shareholders and managers. On repeated games, see ROBERT AXELROD, THE EVOLUTION OF COOPERATION 12, 182-83 (1984).

182 What I mean is the institution of choosing exit rather than voice. *See* Black, *Shareholder Passivity*, *supra* note 13, at 522-24. The historical tendency by market participants to choose exit rather than voice is sometimes referred to as the "Wall Street Rule," given that sophisticated Wall Street investors often chose this path. *See* Easterbrook & Fischel, *Voting*, *supra* note 32, at 417 (discussing the Wall Street Rule).

183 *See* EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 83 & n.33 ("Given the combination of a collective action problem and easy exit through the stock market, the rational strategy for most dissatisfied shareholders is to sell rather than incur costs in attempting to bring about change through votes." They go on to say, "The greater the availability of the sale or exit opinion, the less desirable is the voting or voice option.").

that it has survived.[184] However, the mere survival of an institution does not qualify it as optimal.[185] Institutions that arise from distributional conflicts in a bargaining context cannot automatically be assumed to be Pareto superior.[186] Rather, the fact that established institutions are hard to change is one explanation for their survival.[187] Thus, from the perspective of bargaining theory, the "Wall Street Rule" is not assumed to be the optimal institution merely because it has survived. This is because changing inefficient institutions requires, among other things, a change in the social expectations of the individual actors involved.[188]

Another point that must be recognized is that the level of bargaining is not the same in all types of manager-shareholder interactions. For example, when shareholders bargain through a representative, the level of bargaining is greater than when they bargain tacitly with managers. Thus, the level of bargaining can be characterized as lying on a continuum ranging from implicit, tacit bargaining by individual shareholders to direct bargaining through representatives. Bargaining theory focuses on the strategic behavior of managers and shareholders at both ends of the continuum.

In this section I have set forth how shareholders are involved in explicit and tacit bargaining with managers. Furthermore, I have argued that shareholder-manager relations have begun to move into an era of increased explicit bargaining by shareholders through their representatives—institutional investors. Now that we have seen how

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For a discussion of why shareholders may choose not to participate in "voice" so as to keep their "exit" options open, see Coffee, *Liquidity Versus Control*, *supra* note 16, at 1281 ("Investors that want liquidity may hesitate to accept control."). For a discussion of the traditional theory that shareholder passivity is inevitable, see Black, *Shareholder Passivity*, *supra* note 13, at 526-29; *see also* Easterbrook & Fischel, *Voting*, *supra* note 32, at 402 ("Indeed, the collective choice problems that attend voting in corporations with large numbers of contracting parties suggest that voting would rarely have any function except in extremis.").

184 For example, Fama and Jensen assert that their "goal" is to explain the survival of organizations characterized by separation of "ownership" and "control." Fama & Jensen, *supra* note 31, at 301. They later emphasize the important role of the easy transferability of shares and the role of the capital markets (through the "exit" mechanism) in disciplining managers. *Id.* at 312-13. Easterbrook and Fischel find it necessary to justify why the institution of voting has survived at all, given collective action problems and the ease of exit. Easterbrook & Fischel, *Voting*, *supra* note 32, at 402, 406-08, 420.

185 *See* KNIGHT, *supra* note 86, at 96-97 (noting that the empirical evidence does not support evolutionary theories); Victor Goldberg, *Relational Exchange: Economics and Complex Contracts*, *in* THE ECONOMIC NATURE OF THE FIRM, *supra* note 108, at 90.

186 This is because they arise in a context where power asymmetries influence the bargaining outcome. *See* KNIGHT, *supra* note 86, at 36-37.

187 On the issue of "path-dependence," see NORTH, *supra* note 68, at 93-95, 100; *see also* KNIGHT, *supra* note 86, at 127 ("Once an institution is established, change comes slowly and often at considerable cost. Institutional change entails a change in the equilibrium outcome that social actors have come to recognize as the commonly anticipated solution to problems of social interaction.").

188 KNIGHT, *supra* note 86.

shareholders and managers bargain, the next two sections will address the mechanics of shareholder-manager bargaining in greater detail, by dealing with the issues of bargaining power and bargaining breakdown.

3. *Bargaining Power and Shareholder-Manager Bargaining*

We now consider how a party's bargaining power affects the bargaining outcome. In some situations one party may have certain bargaining advantages, or bargaining power, over her opponent.[189] Taking into account these power asymmetries among parties allows us to build a more complete bargaining scenario.[190] A party with bargaining power can influence her opponent's choice and therefore extract an outcome preferable to that which would otherwise be possible.[191] Specific types of bargaining power are discussed below.

a. *Informational Asymmetry*

The existence of informational asymmetries can influence bargaining outcomes. A party with superior information regarding objective factors in the bargaining process will have a bargaining advantage. For example, if Ann and Sofia are bargaining over the sale of a house, the fact that Ann (but not Sofia) knows that a landfill is being planned right around the corner will give Ann a bargaining advantage.

The main bargaining advantage possessed by managers is that they have superior information concerning their own performance, the performance of the company, and the alternative projects and policies available. Furthermore, managers have better information about the level of their investment in firm-specific human capital, which would be lost if they were replaced by other managers. Thus, managers are better able to ascertain the true value of the substantive and procedural stakes to be divided and the alternatives available if there is a bargaining breakdown.

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189 To illustrate, in a bargaining game between Ann and Sofia, Ann exercises power over Sofia if Ann can affect the alternatives, or set of feasible alternatives, available to Sofia. For example, Ann may be able to limit Sofia's alternatives so as to preclude certain ones that would be in Sofia's best interest, or Ann can alter Sofia's valuation of certain alternatives by threatening to retaliate against Sofia. *See* KNIGHT, *supra* note 86, at 41-42.

190 Using the concept of power to explain the actions of parties requires that one be able to identify the power asymmetries *ex ante*. If this is not possible, one can use the concept of power only as an *ex post* rationalization for action, in which case it loses most of its explanatory force. *See* KNIGHT, *supra* note 86, at 41.

191 Under standard bargaining theory the party with greater bargaining power will receive a larger piece of the pie being divided. *See id.* at 132; JOHN MAYNARD SMITH, EVOLUTION AND THE THEORY OF GAMES 105 (1982). The credibility of a party's commitment to taking a certain action is directly affected by the cost of bargaining and, hence, by the power asymmetries present. *See* JON ELSTER, THE CEMENT OF SOCIETY: A STUDY OF SOCIAL ORDER 72 (1989).

b. *Time Preference*

Another cause of power asymmetry in bargaining is the fact that bargaining is costly.[192] The party who can better bear the costs of bargaining will have a bargaining advantage. One of the costs of bargaining is time:[193] the greater the number of offers and counteroffers and the greater the time interval between them, the costlier bargaining will be. A party that can no longer afford the bargaining process may have to accept an otherwise unsatisfactory resolution. Each party will have preferences regarding when it wants to receive the payoffs of bargaining. A party who can afford to wait for future payoffs will have a bargaining advantage over a party who prefers more immediate payoffs. The patient party will be better able to credibly communicate to the other party that she does not mind waiting,[194] while the less patient party will prefer a smaller slice of the pie now to a larger slice in the future.[195]

Trying to measure the relative time preferences of shareholders and managers is not as straightforward as dealing with the issue of informational asymmetry. First, the relative time preferences may vary from company to company. For example, if the managers negotiating with the shareholders are close to retirement[196] or the company is close to bankruptcy,[197] the managers may discount the future by a greater amount than they would otherwise. Furthermore, if the shareholders have large share holdings that they cannot readily sell without negatively affecting the market price, they will discount the future less than if they could easily and costlessly "exit" the firm.

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192 *See* ELSTER, *supra* note 191, at 69; Kennan & Wilson, *supra* note 103, at 45.

193 *See* JOHN G. CROSS, THE ECONOMICS OF BARGAINING 12-13 (1969):

> [T]he passage of time has a cost in terms of both dollars and the sacrifice of utility which stems from the postponement of consumption, and . . . it is precisely this cost which motivates the whole [bargaining] process. If it did not matter when the parties agreed, it would not matter whether or not they agreed at all.

(emphasis omitted).

194 *See* ELSTER, *supra* note 191, at 75.

195 One can measure time preference by looking at the parameters by which each party discounts the future. *See* KNIGHT, *supra* note 86, at 135.

196 Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), presented such a situation. One reading of the *Van Gorkom* case suggests that the chairman negotiating the sale of the company was close to retirement and therefore wanted to resolve the investment tax credit issue that had long been a problem for the corporation. For further discussion of *Van Gorkom* and bargaining theory, see *infra* part III.A.

197 For a discussion of why managers take more risks when they are closer to bankruptcy, see Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277 (1991); *see also* Credit Lyonnais Bank Nederland, N.V. v. Path Communications Corp., Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991) (Footnote 55 of the case discusses the incentives of shareholders and managers as a corporation gets close to insolvency.).

The relative time preferences of the parties play a larger role when the issues being negotiated involve procedural stakes or the possible replacement of managers. This is because the resolution of the conflict over procedural stakes will affect future bargaining between shareholders and managers. Relative time preferences also play a role in deciding the distribution of substantive stakes. For example, managers may be willing to take a relatively smaller slice today if they know that they will be around for a long time to receive future payoffs.[198]

Negotiations on certain corporate issues may go on for a long time. One example is long term capital expenditure projects. Negotiations regarding such projects extend beyond the proxy season, although it is then that shareholders can make their most credible threats.[199] The longer the negotiation period, the greater the importance of the relative time preferences of shareholders and managers.

c. *Fixed Costs*

Bargaining also involves certain direct costs, such as fees paid to lawyers, proxy solicitors, investment bankers, brokers, and other agents,[200] and the opportunity costs of those involved in bargaining.[201] The party with the lowest fixed costs, everything else being equal, will have a bargaining advantage, particularly if the negotiations are prolonged. In the shareholder-manager bargaining scenario, managers have a definite advantage because the corporation—and, indirectly, the shareholders—bear the fixed costs of negotiating. This includes the cost of the company's lawyers during informal negotiations and the cost of defending management during a proxy battle.[202]

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198 Of course, the greater the increase in shareholder activism, the lower the probability that managers will be able to retain their jobs indefinitely and, therefore, the more managers will discount the future.

199 During other periods the shareholder could threaten to vote in a certain way during the next proxy season or to "exit" the corporation.

200 *See* Kennan & Wilson, *supra* note 103, at 45. For example, let t = time and assume a bargaining surplus of $1.00. Next assume that for every unit of time, t, Ann incurs a fixed cost of $.05$t$ and Sofia a fixed cost of $.2$t$. Thus, one must subtract these fixed costs from the proposed payoff from bargaining. So, if Ann offers to split the surplus (.75, .25) with Sofia at time t, Ann would get (.75-1(.05)) and Sofia would get (.25-1(.2)). If instead Sofia makes a counteroffer of (.60, .40) at time t=2, Ann would get (.60-2(.05)) and Sofia would get (.40-2(.2)), which is less than Sofia would get if she settled at t=1. Thus Sofia cannot credibly threaten to hold out to t=2, given her counter-offer of (.60, .40). *See* ELSTER, *supra* note 191, at 72 (explaining Rubinstein's bargaining paradigm).

201 For example, the CalPERS board recently chided its chief executive officer, Dale Hanson, for spending too much time on shareholder activism and not enough time running CalPERS. Anders, *supra* note 163, at A1.

202 The majority rule is that managers will be reimbursed for the expenses of defending a proxy battle; insurgents will only be reimbursed if they are successful. *See* Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291 (N.Y. 1955). For a critique of this

d. *Risk Aversion*

Bargaining power is also influenced by the parties' relative risk aversion[203] and their relative breakdown values.[204] A party with low risk aversion or who is risk neutral will have a bargaining advantage over a party who is more risk averse.[205] By the same token, a party who has less to gain from a positive bargaining outcome will also have a bargaining advantage. Such a party can credibly communicate that she is less concerned about a bargaining breakdown.[206] The party may care less than the others because she has access to other options or resources outside of this particular bargaining context.[207]

The relative risk aversion of managers and shareholders varies according to the situation. Under finance theory, shareholders are usually assumed to be risk neutral because they can diversify their portfolios, thereby reducing their company-specific risk.[208] However, this assumption does not always hold true when institutional investors acquire large stakes in companies.[209]

Finance theory also casts managers as risk averse on the grounds that they have invested human capital that they cannot diversify.[210] However, this assumes that there is an efficient market for managers that discounts the value of managers' firm-specific skills and expertise. But it is not clear that there is such a high degree of efficiency in the market for managers.[211] Some commentators model managers as risk

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rule and the negative incentive it creates, see Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071 (1990).

203 The level of risk aversion is influenced by a number of factors, including subjective attitudes toward risks and the relative wealth of the parties (i.e., if Ann is wealthier than Sofia, she will be willing to take more risks). *See* ELSTER, *supra* note 191, at 80-81.

204 One can think of breakdown values as those resources and other options that are available to each party if bargaining breaks down. *See* KNIGHT, *supra* note 86, at 132.

205 *See* ELSTER, *supra* note 191, at 80-81.

206 *See id.*

207 For example, if one party is wealthier than the other or has learned to be content with less, or if she has access to other similar options (i.e., if there is competition) then that party will have bargaining power. *See* KNIGHT, *supra* note 86, at 132. Some degree of bilateral monopoly is required in a bargaining situation. If not, one or both of the parties may be able to opt costlessly for a competitor's alternative options. *See* Kennan & Wilson, *supra* note 103, at 47 n.7.

208 *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 137-39 (4th ed. 1991) (The risk of any stock can be broken into two parts. There is unique risk which is peculiar to that stock, and there is market risk which arises from market-wide perils which threaten all businesses. Investors can eliminate unique risk by holding a well-diversified portfolio.).

209 *See* GORDON & POUND, *supra* note 164, at 4 (discussing the risk to institutional investors of taking substantial positions and becoming involved in inducing corporate change, which "open up the possibility of substantial losses if their strategies backfire").

210 *See* Fama, *supra* note 31, at 291-92.

211 *See supra* notes 56-60 and accompanying text.

neutral.[212] Whatever the case, the party with the higher level of risk aversion will be at a bargaining disadvantage.

e. *Retaliation*

The ability and willingness to retaliate against an opponent is another bargaining advantage because the payoff to the party suffering retaliation is reduced by the amount of punishment inflicted.[213] Therefore, the threat of retaliation may lead a party to accept an otherwise unsatisfactory outcome to avoid this cost. Retaliation, however, is usually costly to the party inflicting it, which may in turn call into question the credibility of the threat.[214]

Managers can retaliate against institutional investors in a number of ways. For example, managers can reduce or eliminate institutional investors' access to soft information[215] or refuse to hire activist money managers to run company pension funds.[216] Managers can also resort to more general retaliation against shareholders by taking actions that will reduce the company's value in the short term, thus hurting shareholders with short time horizons.[217]

Shareholders can retaliate against managers by voting them out of office or by exiting the corporation. They can also bring derivative suits if a manager has violated a fiduciary duty.[218] Thus, in the corporate bargaining context, both managers and shareholders have retaliatory mechanisms at their disposal. The net effect on relative bargaining power will vary with the circumstances.

4. *Bargaining Breakdown, Informational Uncertainties, and Other Inefficiencies of Bargaining*

As we have seen, in a bargaining game each party tries to maximize the value of the distributions it receives. This distributional conflict can have a number of negative effects.

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212 *See, e.g.*, WILLIAMSON, *supra* note 70, at 389 & n.5.

213 If we assume that Sofia prefers X' to X, but Ann can inflict a punishment, C, on Sofia for choosing X', then at some point X > X'-C and Sofia will opt for X. *See* KNIGHT, *supra* note 86, at 135.

214 *See* KNIGHT, *supra* note 86, at 135; SCHELLING, *supra* note 131, at 35-43.

215 This would put the money manager running the fund at a disadvantage in her competition with other money managers. *See* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 469-72 & n.83 (1991).

216 *See id.* at 469-71; Black, *Shareholder Passivity*, *supra* note 13, at 595-600.

217 Fiduciary duties can be seen as a way of limiting management's bargaining power. In this way the law limits general retaliation by managers.

218 Statutes such as Delaware's corporations law allow managers to be reimbursed for monetary damages arising out of violations of the duty of care. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (1993). Officers' and directors' insurance also helps mitigate the usefulness of this retaliatory device.

One negative effect is the possibility that no agreement will be reached at all and that the whole bargaining surplus will be lost.[219] In other words, there may be a bargaining breakdown. For example, the distributive conflict between shareholders and managers may lead to a company's bankruptcy or to the rejection by shareholders or managers of a transaction that would have otherwise produced a surplus, such as a takeover, the issuance of new shares to finance expansion, or the disposition of under-performing assets.[220]

Another negative effect is that some of the bargaining surplus may be dissipated even if an agreement is reached because of the cost of the parties' strategic behavior.[221] This second type of inefficiency is more prevalent because both shareholders and managers have incentives to engage in strategic behavior and any such behavior dissipates the bargaining surplus.

In either case, the parties reach a socially inefficient result.[222] These distributional losses occur because in the usual bargaining context there exists no authoritative rule for dividing the stakes of the game.[223] As a result, parties need to agree on how to divide the stakes, and in doing so, will engage in tactics meant to lead their opponents to accept outcomes that are less favorable and that they would otherwise reject.[224]

The existence of informational uncertainties can also lead to inefficient results through distributional losses.[225] There are two types of informational uncertainty that affect bargaining outcomes and increase the possibility of a bargaining breakdown: uncertainty regarding the preferences of the other party and uncertainty due to

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219 Engaging in such distributional conflict increases the probability that no agreement will be reached. *See* ELSTER, *supra* note 191, at 82; Cooter & Marks, *supra* note 136, at 227-28.

220 The fact that shareholders often vote with managers on some of these issues does not mean that they are not bargaining with managers. It just means that the shareholders' best possihle strategy, given managers' bargaining power, is to side with management.

221 *See* ELSTER, *supra* note 191, at 82. This second negative effect, which we can call "strategic bargaining costs," is different from agency theory's concept of agency costs. Strategic bargaining costs will comprise the monitoring costs, bonding costs, if any, and residual loss of agency theory. However, agency costs fail to capture the essence of strategic bargaining costs—the strategic behavior of parties intent on maximizing their share of distributions. In a sense, the distinction is similar to the distinction drawn by Robert Cooter between the Coase Theorem and the Hobbes Theorem. *See* Cooter, *supra* note 131, at 18. Agency theory is too optimistic about the ability of parties to cooperate and fails to give proper acknowledgement to the effects of distributional conflict.

222 *See* ELSTER, *supra* note 191, at 82.

223 This is because, as Cooter points out, production of the good depends on agreement over the distrihutional issue. *See* Cooter, *supra* note 131, at 17; Cooter & Marks, *supra* note 136, at 227-28.

224 *See* KNIGHT, *supra* note 86, at 127; Cooter & Marks, *supra* note 136, at 227-28.

225 On bargaining with imperfect information, see Kennan & Wilson, *supra* note 103.

informational asymmetries regarding objective facts that are important to the bargaining context.

One party's uncertainty regarding the other party's preferences can yield inefficient results. A party may be characterized as a bundle of observable and unobservable traits.[226] That party's opponent can form subjective estimates of the probability of various actions based on the party's observable traits. After repeated interactions, the opponent will adjust these subjectively determined probabilities, and, over time, the subjective estimates begin to correspond with the actual objective frequencies of the actions. Thus, the opponent's expectations will match the objective probabilities associated with parties who have the same observable traits.[227] However, even at this equilibrium point, bargaining breakdowns occur because unobservable traits remain.[228] The existence of unobservable traits explains why a party's actions may differ from those of parties with similar observable traits—i.e., why the subjective distribution may differ from the objective distribution.

A second form of informational uncertainty is produced by objective facts.[229] One party may know more than the other about the bargaining stakes or about alternative outcomes or actions. This sometimes leads to socially inefficient outcomes.[230]

Distributional losses are also produced by parties' attempts to manipulate the bargaining environment. This behavior may include strategically distorting bargaining preferences, manipulating the physical environment to gain a bargaining advantage, and influencing third parties (such as the government) to shape the bargaining parameters through laws and other actions that affect the disagreement point.[231] Some of these efforts, however, may actually reduce distributional losses. For example, shareholders may change the bargaining outcome by having the Securities and Exchange Commission adopt more

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226 Uncertainties regarding the preferences of other parties may include uncertainties regarding time preference, risk aversion, fixed costs of bargaining, and the utility gains from achieving a bargain. Furthermore, where bargaining stakes are multidimensional, there may be uncertainty regarding the subjective tradeoffs among the different components comprising the stakes. *See* ELSTER, *supra* note 191, at 82-83. Some of these preferences may be inferred from the observable traits, but many of them will remain as unobservable traits. When bargaining involves repeat players, the number of traits going from unobservable to observable will increase.

227 *See* Cooter & Marks, *supra* note 136, at 232-33.

228 *Id.*

229 *See* ELSTER, *supra* note 191, at 83.

230 There is a wide variety of literature on the issue of informational asymmetry. *See, e.g.*, Lucian A. Bebchuck, *Litigation and Settlement Under Imperfect Information*, 15 RAND J. ECON. 404 (1984); Sushil Bikhchandani, *A Bargaining Model with Incomplete Information*, 59 REV. ECON. STUD. 187 (1992); Kennan & Wilson, *supra* note 103.

231 *See* ELSTER, *supra* note 191, at 88-91; NORTH, *supra* note 68, at 58-59.

stringent disclosure rules, thereby reducing some of the informational uncertainties.

Managers' greater discretion over the bargaining environment, however, is a significant source of bargaining power. Managers have the power to make investment decisions for the corporation and can determine the amount of effort they will expend in managing the company. Furthermore, managers decide how much company-specific information and knowledge they will acquire.[232] The more they invest in company-specific knowledge, the more efficiently the company will operate. These factors affect the net organizational revenues produced. Furthermore, they give managers bargaining leverage over shareholders.

Shareholders, through strategic behavior, can also change the bargaining environment by affecting the level of net organizational revenues produced. Shareholders have the power to remove managers.[233] They can also refuse to provide additional capital to the corporation or make it more expensive for the corporation to raise capital by "exiting" the corporation and putting downward pressure on the price of its shares. Because shareholders do not have the same information as managers, their behavior may produce inefficiencies. For example, they may decide to remove managers who have acquired company-specific information and who are really performing better than their replacements would perform, at least in the short run.[234]

The strategic nature of bargaining also leads to inefficiencies. Parties become accustomed to disguising their preferences and making threats at the expense of the credibility of their message. Words thus become cheap and must be replaced by actions. But actions are expensive, and threats may not be credible unless they are occasionally carried out. In addition, precommitting to certain strategies may lead to a bargaining breakdown. In either case, social losses result.

The shareholder-manager context illustrates that the strategic nature of bargaining can generate inefficient results. For example, shareholders may not trust[235] a manager who says that she will not work for reduced compensation, and the manager, in return, may

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232 How much of this information they will acquire is a function of how long they predict their employment with the company will last.

233 They can do this by virtue of their power to elect board members. *See* DEL. CODE ANN. tit. 8, § 211(b) (1993).

234 Furthermore, managers may be reluctant to acquire company-specific information if they are afraid that shareholders will remove them at the first sign of trouble. This may be one reason why we do not see shareholder action causing much manager turnover.

235 *See* ARROW, *supra* note 100, at 23 ("Trust and similar values, loyalty or truth-telling, are examples of what the economist would call 'externalities.' They are goods, they are commodities; they have real, practical, economic value; they increase the efficiency of the system, enable you to produce more goods or more of whatever values you hold in high esteem.").

find it necessary to back her threat with action—by quitting, which may be the inefficient outcome. By the same token, the manager may not believe the shareholders' threat to fire her, and the shareholders may be forced to do so to make future threats credible to other managers.

III
Bargaining Theory of the Firm: Applications and Prescriptions

This Part sets forth concrete examples showing how bargaining theory differs from agency theory. The claim is that bargaining theory explains the relationship between shareholders and managers in a more complete and coherent way. In particular, this Part analyzes how bargaining theory prescribes different solutions in a number of legal and institutional areas affecting the shareholder-manager relationship.

A. The *Van Gorkom* Case and Bargaining Theory

In 1985, the Delaware Supreme Court decided *Smith v. Van Gorkom*,[236] a class action lawsuit brought by shareholders of Trans Union Corporation seeking damages resulting from a merger. The shareholders alleged that Trans Union's board of directors violated its fiduciary duty in approving the merger by failing to acquire sufficient information to make a decision. The court agreed and found the directors grossly negligent.[237] The court held that the protection of the business judgment rule, the "presumption that . . . directors acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company,"[238] was not available because the board was not sufficiently informed.[239]

1. *The* Van Gorkom *Case: An Agency Theory Approach*

Judge Frank Easterbrook and Professor Dan Fischel argue that the duty to be informed, imposed in *Van Gorkom*, is "anomalous" and that the opinion, as an example of business judgment jurisprudence,

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236 488 A.2d 858 (Del. 1985).

237 *Id.* at 893.

238 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

239 *Van Gorkom*, 488 A.2d at 872. The new standard set forth in the *Van Gorkom* opinion was unexpected by the Delaware bar and inspired a great deal of commentary, most of it negative. *See, e.g.*, Dierdre A. Burgman & Paul N. Cox, *Corporate Directors, Corporate Realities and Deliberative Process: An Analysis of the* Trans Union *Case*, 11 J. Corp. L. 311 (1986); Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 Bus. Law. 1437 (1985); Leo Herzel & Leo Katz, Smith v. Van Gorkom*: The Business of Judging Business Judgment*, 41 Bus. Law. 1187 (1986).

is an "outlier."[240] They argue that judicial inquiry into the amount of information gathered and reviewed by directors in making their decisions is the sort of interference that the business judgment rule is meant to prevent.[241] There are limits to how much information managers and board members need to make a good decision.[242] Easterbrook and Fischel view the problem as one of ascertaining who—managers, shareholders, or courts—should determine how much information this is. They conclude that allowing shareholders and courts to make this determination will lead to inferior results, given that managers are guided by "the best incentives" in making these decisions.[243]

2. *The* Van Gorkom *Case: A Bargaining Theory Approach*

Managers use information in different ways. First, they use it to make decisions on behalf of the corporation, such as investment decisions, the development of new products, or the approval of extraordinary transactions like the merger in *Van Gorkom*. Second, managers impart information to the capital markets to convince investors to part with their money.

But information is important to managers for another reason—shareholders and the capital markets judge managers based on information about their performance. A number of issues arise if we assume that managers use information in an instrumental manner to enhance the way they are perceived by these observers, thereby strengthening their bargaining position. It is to these issues, not fully addressed by current theories, that I now turn.

When a company experiences a bad outcome, it is difficult to ascertain who or what was responsible. In order to identify the responsibility of management, management's effect on the outcome must be distinguished from that of extraneous variables. Ironically, it is managers who begin the analysis by gathering information about decisions that may have led to the outcome. It is they who then use that information to distinguish managerial mistakes from other causes.

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240 *See* EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 107. The duty to be informed was not a new addition to the duty of care. For some earlier cases, see Bates v. Dresser, 251 U.S. 524 (1920); Bowerman v. Hamner, 250 U.S. 504 (1919); Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).

241 *See* EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 107.

242 Easterbrook and Fischel believe that managers should "spend on knowledge only to the point where an additional dollar generates that much in better decisions." *Id.* at 108.

243 *Id.* Shareholders certainly feel differently about the issue, as was shown in an empirical study by two University of Michigan researchers. *See* Bradley & Schipani, *supra* note 64, at 42-69.

Managers act strategically in undertaking this task of self-examination. They want to emphasize that the bad outcomes were the product of random variables rather than managerial mistakes or other causes they should have foreseen. Their investigative zeal, after the fact, will leave a lot to be desired. Even more importantly, given the possibility of bad outcomes and managerial accountability, managers' efforts to document their actions will be similarly apathetic unless they are bound by some prior obligation to do so. In other words, no documentation at all is often better than having the wrong decision on file. The absence of documentation, managers hope, will be attributed to the fact that the area of corporate decisionmaking is one of imperfect information. This problem is not limited to corporations. There is a long-standing debate among lawyers, especially those in transactional practice, over the extent to which actions should be documented. It usually boils down to an issue of whether notes from meetings and telephone calls, and early drafts of documents, should be filed away for future reference and protection or be destroyed to avoid "discovery" in any future litigation.

We can now see how bargaining theory helps us to explain the *Van Gorkom* case. The *Van Gorkom* case in effect requires managers and board members to leave a "paper trail" documenting actions taken in reaching corporate decisions.[244] This requirement not only increases the probability that managers' decisions will be good, but also helps reduce the *ex post* strategic behavior identified above.

In a sense, *Van Gorkom* imposes a penalty default rule:[245] managers must memorialize their actions, especially in such extraordinary transactions as takeovers, or they will lose the protection of the business judgment rule. The economic rationale behind such a rule is that it will be cheaper for managers to memorialize their actions than to try to reconstruct their actions during a later trial. The fact that managers are encouraged to memorialize their actions will in turn affect the bargaining scenario by making it easier for shareholders to monitor and enforce their bargains with managers.

One additional advantage of the penalty default rule is that it lowers the cost of bargaining without requiring actual disclosure. There are many reasons why we might want managers to refrain from disclosing certain records and information immediately to shareholders, par-

244 *See* Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom after* Van Gorkom, 41 BUS. LAW. 1 (1985).

245 *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989) ("Penalty defaults are designed to give at least one party to the contract an incentive to contract around the default rule and therefore to choose affirmatively the contract provision they prefer. . . . [P]enalty defaults are purposefully set at what the parties would not want—in order to encourage the parties to reveal information to each other or to third parties (especially the courts).").

ticularly when the information is of the sort that becomes useful only during litigation. Requiring too much disclosure, after all, would have the adverse effect of drowning shareholders in information, not all of which would be relevant to trading or corporate governance decisions.[246] The materiality requirement in securities law, for example, has often been justified on just such a principle.[247] A penalty default rule is an effective way, without much legal intervention, to require memorialization without also mandating immediate disclosure.

There are other advantages to such a rule. For example, after *Van Gorkom*, managers and board members have increasingly turned to third party experts, such as investment bankers and accountants, to make sure that they are acquiring adequate information to make an informed decision.[248] Thus, greater expertise and independence inform the decisionmaking process while also providing other means of monitoring managers, both at the time of the decision and later at the time of evaluation. This is not to say that we should always require using third party experts or hiring computer-toting corporate scriveners to document every management decision.[249] We should still undertake cost-benefit analyses to determine how much documentation is needed. Bargaining theory allows us, however, to identify both the additional benefits of requiring informed and documented judgments and the additional costs of not having such requirements. These costs and benefits need to be included in any cost-benefit formula.

One possible objection to the *Van Gorkom* rule is that we do not need to require managers to memorialize their actions because they already have an incentive to do so.[250] This is due to the so-called "un-

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246 *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448-49 (1976).

247 *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988). Information is subject to a duty to disclose if it is material, that is, if there is a substantial likelihood that it would have been considered significant by a reasonable investor. *Id.* at 230-32. Materiality depends upon the probability that an event will come to pass and the magnitude of the event for the corporation. *Id.* at 238-41.

248 This has been particularly true of takeovers and other extraordinary transactions. *See* E. Norman Veasey, *Further Reflections on Court Review of Judgments of Directors: Is the Judicial Process Under Control?*, 40 BUS. LAW. 1373, 1381 (1985) ("[I]t is suggested that the *Trans Union* case imposes unreasonable exposure to liability and requires artificial preparations by a board before making business decisions, including an extensive paper trial, multiple meetings, and the expense of hiring investment bankers.").

249 The *Van Gorkom* case explicitly rejected such a requirement. *See* Smith v. Van Gorkom, 488 A.2d 858, 881 (Del. 1985).

250 Anybody who reads the corporate minutes of a large American company will soon realize that the objective is just the opposite: to minimize the amount of information preserved. The rationale is to avoid having any such information disclosed in future litigation. The corporate minutes in many other countries are much more detailed. These observations are from my four years in practice in a Wall Street law firm.

ravelling" effect of information.[251] The argument is as follows: The market assumes that firms with nothing to hide will adequately memorialize their actions, while firms anticipating problems will memorialize relatively little. In order to gain the trust of the market, managers will be inclined to memorialize an optimal proportion of their actions and somehow signal to the market that they have done so. However, the argument does not apply to the *Van Gorkom* rule, which requires memorialization of managerial actions to make it possible to discipline managers in future court proceedings. Because the information memorialized cannot usually be verified until litigation begins, its constraining effect on managers will be diffused. More importantly, as mentioned in the next subpart (discussing mandatory disclosure), the unravelling effect is not very powerful in the corporate context, given that the variables being compared are not discrete. In other words, the unravelling effect is more useful when analyzing simpler cases where the variables involved are easier to compare.[252]

The penalty default rule will not resolve all issues of the verifiability of information. In some cases it may be impossible to tell what managers have failed to memorialize. However, two factors will often help police managerial misbehavior. One is the judicial process, in which discovery and the threat of prosecution for perjury have a salutary effect on managerial amnesia. Second, the nature of large corporations and managerial ranks makes it hard for the managers to know how much others within the organization know. This increases the possibility of conviction for perjury.

Of course, we do not want to require the memorialization of too much information. An excessively stringent requirement would meet with the futile results of the mapmaker in the Borges story who was asked to produce as precise a map as possible and wound up producing a map of the size of the kingdom.[253] Requiring memorialization of extraordinary transactions, such as the takeover in *Van Gorkom*, however, should not be too controversial. In addition, memorialization of managerial action would be appropriate in certain other circumstances, including investment decisions, especially those that could lead to managerial entrenchment;[254] changes in the firm's capital structure; the adoption of antitakeover provisions; and managerial

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251 *See* DOUGLAS G. BAIRD ET AL., GAME THEORY AND THE LAW 89 (1994); EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 289 (discussing managers' incentives to disclose information voluntarily).

252 *See infra* part III.B for more discussion of unravelling effects.

253 *See* JORGE LUIS BORGES & ADOLFO BIOY CASARES, EXTRAORDINARY TALES 123 (Anthony Kerrigan ed. & trans., 1971).

254 *See infra* part III.D for a further discussion of the issue of managerial entrenchment.

decisionmaking regarding managers' own compensation[255] and evaluation.

B. Mandatory Disclosure Requirements

Easterbrook and Fischel, as well as other agency theorists, have argued that mandatory disclosure rules, such as those in the federal securities laws, are largely unnecessary because managers have market incentives to disclose adequate information voluntarily. First, better managers will have an incentive to inform the market of their superior performance.[256] Second, managers will find it difficult (and costly) to sell securities unless they can provide the market with sufficient information.[257] This is, in essence, an "unravelling effect" argument like that discussed in the prior section.[258] In other words, managers will have an incentive to disclose because the market will perceive those who do not as having something to hide. To avoid this perception, those with good news will disclose it; of the firms remaining, those with relatively good news will disclose theirs, and so on, until eventually everyone has disclosed.

As noted above, an unravelling effect is sometimes felt in simple circumstances. The nature of corporate disclosure, however, makes the unravelling effect less powerful. For example, where the entities making disclosures are not easily comparable, unravelling will be less likely to occur. Take, for example, C & C, Inc. The value of C & C stock will be a function of the information set that the market possesses regarding C & C (including information regarding past earnings, current projects, new products, lawsuits filed against the company, and so on). The information sets of different companies will intersect in some areas. For example, each information set will include industry information and general economic news. However, each will also include company-specific categories. Thus, it will be difficult for a shareholder to assess whether C & C's failure to disclose certain types of information, when other companies have made disclosures, indicates that C & C's management is hiding something.

When discussing the federal securities law requirement of mandatory disclosure by managers, Easterbrook and Fischel state that "[i]f disclosure is worthwhile to investors, the firm can profit by pro-

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255 *See infra* part III.C for a discussion of managerial compensation issues.

256 *See* EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 256 (analysis of the reasons underlying a firm's disclosure of information about itself).

257 *Id.* at 288.

258 For a more detailed discussion of the unravelling effect, see BAIRD, *supra* note 251, at 89-90.

viding it."[259] The implicit assumption is that managers will be better off if "the firm can profit." This is true, however, only to the extent that the managers' share of the surplus produced exceeds their losses from disclosing more information; the more information disclosed, the more carefully shareholders can monitor managers and thereby weaken managers' bargaining position. In other words, it is important to focus on the bargaining context to understand the role disclosure laws play in manager-shareholder relations.

The usefulness of information depends on its timeliness and veracity. These two variables are to a large extent under the control of managers. As mentioned above, managers have the advantage of certain informational asymmetries due to their position in the corporation and the cost to shareholders of acquiring and verifying information. Thus, managers can use delay, lies, and obfuscation to enhance their bargaining position vis-à-vis shareholders. Managers can also retaliate against recalcitrant shareholders by withholding information from them. This is a particular worry of activist institutional investors, who currently have access to soft information from managers through analyst meetings and other direct contact with managers.[260] These are all tools in managers' strategic arsenal. The federal securities laws' mandatory disclosure and anti-fraud provisions are examples of mechanisms that limit the use of these strategic devices.[261]

C. Managerial Compensation

Bargaining theory also gives us a different perspective on the issue of managerial compensation. Let us return to the example of C & C, Inc. set forth in the Introduction—in particular, consider the assumption that managers have continued to give themselves raises even though the firm has suffered financial losses over the previous five years. Given the recent controversies regarding management compensation[262]—increases in which, ironically, are substantially attribu-

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259 Easterbrook & Fischel, The Economic Structure, *supra* note 11, at 288. This is because the "firm is in privity with its investors, and they should be able to strike a beneficial bargain." *Id.* Bargaining theory questions these two conclusions.

260 *See* Black, *Shareholder Passivity*, *supra* note 13, at 606-07.

261 For example, the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78*ll* (1988), and the rules adopted thereunder by the Securities and Exchange Commission require periodic disclosure of information to the capital markets, including an annual report on Form 10K, quarterly reports on Form 10Q, and periodic reports on Form 8K, promptly following any material change. *See* 17 C.F.R. § 249.310 (1994) (Form 10K); 17 C.F.R. § 249.308a (1994) (Form 10Q); 17 C.F.R. § 249.308 (1994) (Form 8K).

262 In a recent empirical study of firms that received a windfall from prevailing in or settling a lawsuit, the authors found that managers had used a substantial portion of the windfall to increase their own compensation. *See* Oliver J. Blanchard et al., National Bureau of Economic Research, Inc., What Do Firms Do With Cash Windfalls? (Work-

table to the very stock option plans that agency theorists claimed would help align managerial incentives with those of shareholders[263]—this example represents a potentially significant type of bargaining scenario between managers and shareholders. Let us analyze how the agency theory of the firm and bargaining theory would deal with this scenario.

Agency theory provides various answers to why managers may continue to give themselves raises in the face of growing corporate losses. The main answer begins with the observation that this "undeserved" compensation is an agency cost.[264] Shareholders would only want to do something about it if the cost of preventing managers from obtaining this "undeserved" compensation were less than the savings to the corporation. Because shareholders have not taken action, agency theorists conclude that managerial acquisition of some amount of "undeserved" compensation is the optimal outcome in an imperfect world. According to agency theory, this does not mean that managers have unfettered discretion in compensating themselves. Managers are subject to certain market constraints, such as the market for managers and the market for corporate control. A company whose managers systematically overcompensate themselves will eventually be weeded out through natural selection because the company will become less competitive in product markets than companies whose managers are compensated according to what they are worth. Managers will, under the agency theory view, take all of these constraints into account when deciding how much to compensate themselves. If these constraints are weak, at some point managers will overcompensate themselves so much that shareholders will find it cost effective to discipline them.

There are, however, a number of problems with using agency theory to analyze these problems. Primarily, agency theory provides minimal guidance to lawmakers or corporate actors trying to make decisions about such problems as managerial overcompensation. The

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ing Paper No. 4528, 1993). They stated, "Perhaps the most striking evidence in this paper [is] . . . that a median of 16 percent of the award is given to the top three executives in the form of extra cash compensation over the next 3 years." *Id.* at 22.

263 *See* Baker et al., *supra* note 44; *see also* Jensen, *Eclipse*, *supra* note 44, at 64-66; Jensen & Zimmerman, *supra* note 31, at 4-6. For example, an empirical study found that where managers in firms received cash windfalls, the median management ownership rose from 14.5% to 16.5% due to stock and option grants to managers. *See* BLANCHARD ET AL., *supra* note 262, at 22. The recent changes in the management compensation disclosure requirements were implemented partly in response to this issue. *See Executive Compensation Disclosure*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,056 (Oct. 16, 1992) (Release No. 34-31327).

264 Undeserved compensation is a tangible and particularly visible form of residual loss. It is therefore an agency cost to the principal. *See supra* note 47 and accompanying text.

guidance that it does provide is at a very abstract level. The principal message is that the status quo is the best that we can do, since it is the inevitable product of market constraints and an evolutionary process. Agency theory tells inquiring lawmakers, "Don't interfere"; and it tells inquiring corporate actors, "You can't get away with too much, since you are subject to certain market constraints."

Managers soon realize, however, that these purported market constraints do in fact allow them a lot of leeway in many areas, including setting their compensation packages. One reason is that there is a time lag between any managerial action and the imposition of discipline by shareholders. As a result, there is time to cover up one's actions, time for the corporation to return to profitability, time to retire, and time to die. A second reason is the existence of informational problems such as the ones described earlier in this Article, which makes it harder for shareholders to know exactly how managers are acting and the extent to which managers are responsible for undesirable corporate outcomes. As a result, the managers of C & C can continue to give themselves raises without suffering the consequences. Agency theory acknowledges that it is costly for shareholders to gather information about managerial compensation and to discipline managers. However, agency theory fails to identify the particular costs involved, the ways in which managers can manipulate those costs, and the proper role of the law in minimizing the costs.

Bargaining theory, by contrast, confronts these issues directly. It recognizes the propensity of managers to act strategically, viewing their compensation decisions as elements of the bargaining game over apportioning net organizational revenue.[265] Clearly, managers want to maximize their share of the substantive stakes. But compensation also plays a role in bargaining over procedural stakes. For example, by awarding themselves "golden parachutes" or other expensive forms of severance payments, managers make it more expensive for shareholders to get rid of them; consequently, managers will occupy superior bargaining positions in future negotiations with shareholders. Whether viewed as retaliation against or increasing the fixed costs to the shareholders, such measures affect the relative bargaining strength of the parties.

Bargaining theory also recognizes that managers' incentives and ability to engage in strategic behavior are enhanced both by informational asymmetries and by time lags between managerial action and shareholder discipline. Thus, bargaining theory suggests a relationship less equal and more open to exploitation than does agency theory.

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265 *See supra* part II.A.1 for a discussion of shareholders and managers bargaining over substantive stakes.

By focusing on these issues, bargaining theory properly cautions shareholders in their dealings with managers and encourages shareholder vigilance. Bargaining theory also suggests a more prominent role for regulation and can provide greater guidance to lawmakers who seek to address such issues.

For example, in 1992 the Securities and Exchange Commission sought to strengthen the disclosure requirements for managerial compensation in order to ensure that shareholders would receive sufficient information to compare compensation schemes across firms.[266] Bargaining theory tells us that such increased disclosure, which relates solely to substantive stakes, will by itself prove insufficient, because managers will continue to use compensation in strategic ways to bolster their future bargaining positions. With this in mind, regulators can adopt more finely-tailored rules to encourage disclosure of strategic behavior (perhaps through penalty defaults), to encourage bargaining between shareholders and managers over these issues, or to restrict strategic uses of certain compensation packages that yield a net reduction in social welfare.[267]

D. Managerial Entrenchment

Practically speaking, it is difficult to remove managers who are underperforming,[268] and managers have ample incentive to make removal as hard as possible. Managers also have the ability to entrench themselves by taking actions that will make it costlier for shareholders to remove them. Managers accomplish this particularly through their control of corporate assets and investment decisions. The following example will help illustrate the potential for managerial entrenchment.

Assume that the managers of C & C, Inc. want to keep their jobs and are faced with two alternative investment opportunities. Investment A has a higher net present value than Investment B. Investment B, however, has certain characteristics that are desirable to managers: (1) if the investment goes awry, the managers can more easily explain

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266 *Executive Compensation Disclosure*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,056.

267 For example, this would be the case if their sole use were strategic, if they led to costs that neither party would otherwise incur, and if these costs exceeded the net benefit of the package.

268 Technically it is not that difficult. Under state law, the power to remove managers is given to the board of directors. Usually only a majority vote by the board is required to remove the managers. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1993). When the board refuses to remove the managers, the shareholders can vote to remove the directors. There are certain technical requirements for the removal of directors. *See, e.g.*, *id.* § 141(k) (removal with and without cause). In addition, as was noted above, there are numerous nonlegal roadblocks to removing directors. In particular, the collective action problem in shareholder voting and managerial control of proxy statements prove problematic.

the poor performance on the basis of extraneous factors rather than bad managing; and (2) it requires long-term commitments that could be revoked by new managers only at a very high cost, which would make a takeover or any other type of change in managers less attractive.[269] Rational managers will choose Investment B if the benefits of further entrenchment exceed the costs.

The received agency theory of the firm assumes that market, contractual, and evolutionary constraints greatly restrict the ability of managers to use their control over corporate assets and investment policy strategically. Agency theorists recognize that managers will have some discretion in making decisions that will foster self-entrenchment;[270] the focus, however, has been on the secondary effects of such decisions on the market mechanisms that constrain managerial behavior.[271] To the extent that managers can take actions which per se increase the costs or decrease the likelihood of shareholder discipline, the markets for corporate control and for managers will be less effective as constraints on managerial behavior.

Economists who have begnn exploring how managers use corporate investment policy to entrench themselves have concluded that the market constraints relied on by agency theorists are thereby rendered largely ineffective.[272] In reality, managers have great discretion to make investment decisions that have the effect of making existing

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269 The more the current managers can tie the hands of future managers, the less flexibility those new managers will have to change company policy. Thus, the benefit of hiring the new team of managers is reduced.

270 During the 1980s a whole literature developed regarding management entrenchment during takeovers. *See, e.g.*, KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER (John C. Coffee, Jr. et al. eds., 1988); Easterbrook & Fischel, *The Proper Role*, *supra* note 134. However, what I have in mind here is entrenchment carried out not during takeover battles but in the day-to-day managing of the company. *See* STIGLITZ & EDLIN, *supra* note 3; Schleifer & Vishny, *supra* note 158.

271 For example, Michael Jensen recognizes the conflict of interests surrounding the payout of cash to shareholders, given that paying out such cash reduces the resources under management's control and makes it more likely that managers would be subjected to the disciplining effect of the capital markets (because they would be required to tap these markets to raise capital). Shareholders have an interest in having managers pay out any "free cash flows" (that is, any cash flows in excess of that which is required to fund all positive net present value projects). *See* Jensen, *Free Cash Flow*, *supra* note 5, at 323. Jensen argues that the market for corporate control will help constrain managers' retention of free cash flows, by making it more likely that the relevant corporation will be taken over so that the acquiring company can get to the free cash flows. *Id.* at 328. Jensen also views the leveraging of corporauons as a way that managers contractually agree to pay out free cash flows in the way of interest payments, so that the institutions receiving the interest payments can reinvest them more efficiently. *Id.* at 324.

272 *See* STIGLITZ & EDLIN, *supra* note 3, at 1-3. They argue that "neither the take-over mechanisms nor the shareholder-voting mechanism may exercise effective discipline" and that informational asymmetries provide managers with great discretion. *Id.* at 2; *see also* Shleifer & Vishny, *supra* note 158, at 122 (argning that the disciplinary forces provided by the board of directors, the managerial labor market, the products market and the market for corporate control "do not appear to be totally effective").

managers more valuable to the firm than a replacement management team.[273] These observations are consistent with bargaining theory's focus on managers' use of strategic behavior to gain bargaining advantages in subsequent bargaining rounds.

Bargaining theory focuses on how the existence of informational asymmetries makes it easier for managers to entrench themselves. The shareholders of C & C, for example, would find it very costly to acquire the information needed to ascertain the exact characteristics of Investments A and B, and to discover whether there were other possible investment options, such as Investment C, that managers did not consider or considered but rejected for entrenchment reasons. Bargaining theory focuses on the effects of fixed costs that managers can impose on shareholders through such investment decisions.

By focusing on the strategic nature of investment decisions we can better address questions that are critical from a corporate governance point of view. How should shareholders analyze issues of entrenchment when deciding how and whether to discipline managers? How should lawmakers react to entrenchment by managers? If shareholders focus on the procedural implications of the entrenching acts of managers, they will view these entrenchment decisions as more costly than the lens of agency theory admits. Bargaining theory recognizes the costs by viewing entrenchment decisions as part of the procedural stakes. In such cases, shareholders should be willing to undertake more direct disciplining actions.

The challenge for lawmakers will be to make the bargaining interaction between shareholders and managers more efficient. This may involve more stringent disclosure requirements or compulsory memorialization of the managerial decisionmaking process, to make it easier for shareholders to discipline managers. A penalty default scheme like the one discussed above would serve these functions: for example, managers who failed to adequately memorialize their decisionmaking process would be denied the protection of the business judgment rule.[274] However, lawmakers should be hesitant about restricting the types of investments that managers can undertake or the types of capital structures and governance provisions that they can

273 *See* STIGLITZ & EDLIN, *supra* note 3, at 5 ("The information imperfections which underlie managerial discretion provide management with the opportunity to obtain rents, that is, payments in excess of their opportunity costs."); Shleifer & Vishny, *supra* note 158, at 122 (arguing that managers can "counter disciplinary forces by entrenching themselves, that is, by making themselves valuable to shareholders and costly to replace").

274 *See supra* notes 244-55 and accompanying text for a discussion of how the rule in Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), helps encourage such actions by managers.

adopt,[275] unless such restrictions would make it easier for shareholders to bargain with managers.[276]

E. Firm-Specific Human Capital

Easterbrook and Fischel argue that changing managers is often costly, since managers' investment in firm-specific human capital will be lost. Thus, they conclude that "[b]oth sides try to avoid these costs, the threat of which induces both to perform well in the first place."[277] However, if their acquired capital is useful in other employment, managers will stand to lose less than shareholders. In addition, shareholders may have insufficient information about the value of managerial human capital—after all, managers have an informational advantage in that regard.

Assume a firm with one shareholder and one manager. The manager and the corporation are in New York, and the shareholder is in Tibet. The shareholder, who is not involved in the day-to-day management of the corporation, has only that information about the corporation that the manager gives her.[278] The shareholder is dissatisfied with the performance of the company and is thinking of removing the manager or drastically cutting the manager's compensation. The manager has told the shareholder that any cut in her salary would lead her to quit the company.

The shareholder is uncertain about three things: (1) whether the manager's threat to quit is credible; (2) whether the poor perform-

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275 These last two restrictions are of the type encouraged by Easterbrook and Fischel in their arguments against takeover defenses. *See* Easterbrook & Fischel, *The Proper Role*, *supra* note 134, at 1201-04.

276 Commentators who favor rules allowing the target's manager to solicit competing bids seek to increase the bargaining power of managers vis-à-vis the hostile bidder, so as to give time for an auction to develop. *See* Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982). Decisions like Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), also help encourage bargaining by restricting the bargaining power of managers once an auction situation has developed. In *Revlon*, the court stated that "concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder." *Id.* at 182. Recent takeover battles for Paramount and Grumman have shown that many times, alternative bidders willing to enter into an auction can do so quite rapidly. *See* Laura Landro & Johnnie L. Roberts, *Mixed Media: QVC's $9.5 Billion Bid for Paramount Brings Industry Titans to Fray*, WALL ST. J., Sept. 21, 1993, at A1.

277 EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 97.

278 In other words, assume that the shareholder has the characteristics of a public shareholder except that she does not face the usual collective action problem in shareholder voting. For an explanation of why this assumption makes more sense now that institutional investors are becoming more involved in shareholder voting, see *supra* notes 163-69 and accompanying text. Making this assumption may also yield insights into why the collective action problem and the conflict of interest of money managers may not be the only barriers to shareholder activism.

ance of the company is due to the manager's actions or to exogenous factors; and (3) how much firm-specific human capital the manager has acquired[279]—capital that will be lost if the manager is fired and replaced by another manager who needs to acquire the same knowledge.

Easterbrook and Fischel argue that in a situation like this both the shareholder and the manager will try to avoid the costs of replacing the manager. The threat of the costs incurred by replacing the manager, they believe, will induce both parties to perform well to begin with.[280] This is another example of agency theory's assumption that an efficient bargain will always be struck.

There is no reason to believe, however, that the manager and shareholder will not act strategically in trying to maximize the benefits that each receives. Bargaining theory allows us to analyze this problem more thoroughly by focusing on the existence of a bargaining region and the fact that this will lead to strategic behavior and the possibility of a bargaining breakdown.

In the example under consideration, a shareholder is trying to decide whether to replace the current manager. Assume that the current manager is worth $200,000 a year to the firm. A replacement manager could be hired for a salary of only $100,000 a year, but would be worth only $100,000 to the firm because she does not possess the firm-specific human capital that the current manager possesses. Thus, the question posed to the shareholder is how much to pay the current manager. The $100,000 extra that this manager is worth to the company produces a bargaining surplus to be divided between the current manager and the shareholder. One possibility is to pay the current manager $200,000. But that would give her the whole bargaining surplus. So we would expect the shareholder to offer an amount less than $200,000. There is no assurance, however, that the parties will reach a bargain. If they cannot reach a bargain, the shareholder and the current manager will lose the whole bargaining surplus.[281] Given the uncertainties surrounding the bargaining context, one cannot as-

279 In the course of her employment the manager will acquire two types of human capital: firm-specific and general human capital. General human capital is knowledge and expertise that is equally valuable in another firm. Firm-specific human capital is knowledge that loses all or most of its value if the manager leaves the firm. *See* WILLIAMSON, *supra* note 70, at 254-56 (describing firm-specific capital); Gary S. Becker, *Investment in Human Capital: A Theoretical Analysis*, 70 J. POL. ECON. 9 (Supp. Oct. 1962) (survey of general human capital).

280 *See* EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 97.

281 In other words, the shareholder needs to hire a new manager who is worth only $100,000 to the company. The current manager will now have to try her luck in the market for managers, where per our stipulations, her services (without the firm-specific human capital, which she loses when she leaves the firm) will be worth only $100,000.

sume that the equilibrium outcome will be that a bargain is always reached.[282]

We can learn a number of things from this example. One is that the existence of firm-specific human capital will create a bargaining region. Second, both the shareholder and manager can be expected to expend resources on strategic behavior to shore up their bargaining positions. The manager will act strategically when investing in human capital. She will want to invest in as little firm-specific human capital as possible. She will, however, need to invest in some firm-specific human capital because if she is fungible, she can easily be replaced with another manager. At the same time, the manager will expend resources trying to convince the shareholder that her accumulation of firm-specific human capital has made her indispensable.

The shareholder will want the manager to invest in as much firm-specific human capital as is necessary to rnn the company at its optimal level. If the shareholder often threatens to replace managers or repeatedly carries out the threat, then the managers, who know that they may not be on the job for very long, will underinvest in firm-specific human capital.

Thus we see that both shareholders and managers have incentives to engage in certain strategic behavior. They will therefore incur certain expenditures in anticipation of bargaining. This leads to the dissipation of some or all of the bargaining surplus or may lead to a total bargaining breakdown.[283]

F. Fiduciary Duties: Mandatory versus Enabling Provisions

A recent controversy in corporate law revolves around whether corporate law prescribes or should prescribe mandatory or enabling rules.[284] Bernard Black has argued that by and large corporate law is trivial because it is made up largely of non-mandatory rules.[285] Some agency theorists have argued that shareholders should be allowed to contract around management's fiduciary duties.[286] Again, agency the-

282 *See* Cooter & Marks, *supra* note 136, at 232-33.

283 One can complicate this bargaining game by moving away from an all or nothing game to one in which there are multiple offers. In such cases, asymmetrical bargaining power plays a larger role.

284 *See, e.g.*, John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989); Easterbrook & Fischel, *The Corporate Contract*, *supra* note 22; Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989).

285 *See* Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 544 (1990) (Corporate law is trivial because "it does not prevent companies—managers and investors together—from establishing any set of governance rules they want.").

286 *See, e.g.*, Butler & Ribstein, *supra* note 66.

orists rely on the existence of contractual and market constraints to argue that fiduciary duties should not be mandatory.[287]

The bargaining theory of the firm provides some additional justifications for being cautious about allowing shareholders to contract around fiduciary duties. Under bargaining theory, fiduciary duties can be seen as a constraint on managerial bargaining power. Given their informational advantage and control over the resources and decisionmaking processes of the company, managers unconstrained by fiduciary duties will be tempted to make and carry out certain threats that hurt shareholders.[288] There are many examples, especially in the takeover context, of managers adopting strategies that allowed them to stay in power at the expense of shareholders.[289]

G. Governance Structures and Bargaining Theory

Oliver Williamson has argued that managers have incentives to develop governance structures, such as the board of directors, to prevent opportunistic behavior in situations not contemplated by the original corporate contract. According to Williamson, the board of directors "arises endogenously, as a means by which to safeguard the investments" of shareholders,[290] and to prevent the penalty the firm will face in the capital markets if shareholders are not safeguarded against "expropriation and egregious mismanagement."[291] Williamson's implicit assumption is that managers will gain more from adopting these governance structures than they will lose from greater monitoring by shareholders, because if not, these governance structures would not have survived.[292]

Bargaining theory casts doubts on this conclusion. A major contention of bargaining theory is that rational actors do not automatically undertake every action that produces a collective benefit.[293] A self-interested decisionmaker takes two factors into account: (1) the size of the pie and (2) how the pie will be sliced. While both share-

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287 *Id.* at 18-53.

288 Where sbareholders greatly discount the future (that is, where they need to be able to leave the firm quickly by selling their shares), they are at a particular disadvantage, because managers can threaten to hurt the company's earnings in the short term as retaliation against these shareholders.

289 Adopting anti-takeover devices, paying greenmail, adopting golden parachutes, and actively opposing tender offers are some examples.

290 WILLIAMSON, *supra* note 70, at 306.

291 *Id.* at 305.

292 *Cf. id.* at 22 (noting the plausibility of the general assumption of "the efficacy of competition to sort between more and less efficient modes and to shift resources in favor of the former"). For a critique of this argument from evolution, see *supra* notes 81-85 and accompanying text.

293 *See* Cooter, *supra* note 131, at 20-21 (developing a bargaining game in which, at equilibrium, bargaining sometimes breaks down and both parties are worse off).

holders and managers have an interest in increasing the size of the pie (that is, their collective benefit), both groups have the primary objective of maximizing their own wealth. If making the pie bigger will result in a smaller distribution for managers, managers will opt for the smaller pie.[294]

Determining the distribution of benefits will involve strategic behavior by the parties. The distributional conflict that ensues may lead to decisional deadlocks or bargaining breakdowns or to the wasting away of any potential collective benefit, particularly in situations in which there are informational asymmetries.[295] For example, given that the parties will be bargaining in more than one period, it is conceivable for one of them to threaten to make the pie smaller in the current period to gain a strategic advantage in future periods. Therefore, bargaining theory suggests that existing governance structures do not exist because they are efficient. Rather, they result from maneuvering by parties who are not necessarily interested in maximizing the aggregate welfare.

H. Politics, Bargaining, and Institutions

Politics plays a strong role in the shareholder-manager bargaining relationship. Although agency theorists have not ignored politics altogether, they have focused their efforts in two areas: (1) identifying the socially optimal contract or governance structure and (2) explaining the role that government regulation has played in undermining this optimal structure.[296] In agency theory, government regulation is an exogenous variable.

This approach is not viable because it is impossible to divorce politics from shareholder-manager relations.[297] Managers and share-

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294 Williamson fails to explain why managers would voluntarily engage in reducing agency costs if it led to their getting a smaller share of corporate distributions. KNIGHT, *supra* note 86, at 33-34.

295 Robert Cooter has drawn a distinction between the Coase theorem, with its assumption that parties will reach a bargain, and what he terms the Hobbes theorem. The latter theorem holds that absent a Leviathan, no agreement will be reached. *See* Cooter, *supra* note 131, at 18 (The Hobbesian view "is based upon the belief that people will exercise their worst threats against each other unless there is a third party to coerce both of them."). In essence, agency theory assumes that both parties will reach a Coasean bargain in which they agree to split the collective good.

296 Easterbrook and Fischel tell us in *The Economic Structure of Corporate Law* that the normative thesis of their book is that corporate law should contain those terms that most parties would have negotiated if they had bargained ahead of time (assuming that the cost of negotiating for every contingency were sufficiently low) and that the positive thesis of their book is that corporate law almost always conforms to this model. *See* EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE, *supra* note 11, at 15.

297 *See, e.g.*, Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); William F. Shughart II & Robert D. Tollison, *Corporate Chartering: An Exploration in the Economics of Legal Change*, 23 ECON. INQUIRY 585 (1985).

holders constantly try to convince legislators and courts to change the legal rules regulating their relationship. Managers and shareholders attempt to alter the bargaining context by introducing third parties, such as the government.[298] The emergence of state antitakeover statutes during the late 1980s provides a perfect example of managerial attempts to increase their bargaining advantage in this manner. Recent changes in the proxy rules, and management compensation disclosure requirements demonstrate the success of shareholder activism in influencing government action. However, management made serious attempts to block adoption of these measures and succeeded in watering them down considerably.[299] The bargaining theory of the firm makes this political conflict an endogenous variable by treating it as part of the procedural stakes being divided by shareholders and managers. It therefore provides both a better description of the firm and better guidance to the relevant players.

CONCLUSION

This Article has introduced concepts and paradigms from the game theoretical analysis of bargaining in order to refocus the analysis of shareholder-manager relationships on the role of the parties' strategic behavior. I have argued that the relationship between shareholders and managers can best be conceptualized as an ongoing bargaining game. The bargaining theory that I develop responds to some of the weaknesses of the currently prevailing agency theory of the firm by bringing the role of bargaining to the forefront of the analysis of corporate interactions.

The goal of this Article has not been to provide a complete refutation of the received agency theory of the firm. Rather, I have tried to shake off some of the underlying assumptions that have restricted the objects to which that theory has attended. Certainly, the agency theory of the firm has provided valuable insights. As we have seen, the collapse of the takeover market and the rise of institutional investor activism have called into question some of the key assumptions of the agency theory of the firm. The bargaining paradigm therefore is particularly useful because it provides a framework for analyzing manager-shareholder relations in this new environment.

Bargaining theory attempts to deal with the fact that managers use their discretion to increase both their compensation packages and their bargaining strength in anticipation of future bargaining rounds with shareholders. In other words, shareholders and managers bar-

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298 *See* ELSTER, *supra* note 191, at 87-89; NORTH, *supra* note 68, at 58.

299 *See* comment letters to the Securities and Exchange Commission in connection with *Communication Among Shareholders* [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051 (Oct. 16, 1992) (Exchange Act Release No. 31,326).

gain over both substantive and procedural stakes. Bargaining theory differs from agency theory both practically and methodologically: it includes a more intent focus on such concepts as the strategic behavior of managers and shareholders; the bargaining costs produced by this strategic behavior; the dynamic, ongoing nature of the shareholder-manager relationship; the role of managerial discretion and informational asymmetries in this relationship; and the issue of institutional emergence and change. By emphasizing these issues, bargaining theory attempts to provide more helpful guidance than agency theory, both to lawyers involved in structuring corporate transactions and to judges and legislators contemplating corporate policy.

A more complete analysis of the bargaining context within the firm would include as players other economic actors, such as creditors, employees, and board members. The bargaining theory outlined in this Article will hopefully provide a model that can eventually be expanded to include these other constituencies. With this Article, I hope to have at least shown how bargaining theory rephrases old questions and asks new ones, thus explaining more completely how cooperation and conflict shape corporate interactions.