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TWO MODELS OF CORPORATE GOVERNANCE: BEYOND BERLE AND MEANS†

Lynne L. Dallas*

The recent wave of takeovers requires reexamination of the conclusions drawn from the traditional model of corporate governance. The traditional model is based on the concept that shareholders are "owners" of the corporation who, by virtue of such ownership, are entitled to control the corporation and have it serve their interests alone. This concept supports shareholder rights to elect the board of directors, to vote on certain corporate matters, and to rely on the fiduciary duty of directors to operate the corporation in the best interests of the shareholders. This traditional ownership model rests on the theory that society should recognize the rights of shareholders to control corporations because the shareholders have the incentive to maximize profits.[1] This incentive causes them to utilize factors of production most efficiently and to strive to maximize the satisfaction of human wants.

Takeovers raise a number of questions that challenge the validity of this model. Should acquisition of a particular number of shares automatically entitle a person to treat the corporation as her "property"? Are corporations merely commodities that can be bought and sold, or are they political and social institutions that must be handled in a different way? In decision making, should directors take into account only the interests of shareholders when other constituencies such as employees, creditors, and communities also have a stake in the enterprise? Do shareholders trading their shares in the stock market really have the

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1. *E.g.*, A. Berle & G. Means, The Modern Corporation and Private Property 299-302 (rev. ed. 1967).

incentive to use corporate resources in ways consistent with the long-term health of the American economy?

Similar questions were raised in the 1930's in the wake of the stock market crash. At that time, Berle and Means challenged the traditional ownership model in their classic work, *The Modern Corporation and Private Property*.[2] They focused upon the separation of share ownership and control, cataloguing in great detail the economic and legal changes relevant to control of the public corporation. Shareholders, according to Berle and Means, had become passive owners who assumed no responsibility for or control over the operations of the corporation. Control was in the hands of nonowner managers. It could, therefore, no longer be assumed that those controlling the corporation would use the resources of the corporation most efficiently and seek to maximize the satisfaction of human wants.[3] The traditional model, based on the significance of ownership to control, was no longer valid. Berle and Means concluded that government was justified in intervening in the governance of corporations to ensure greater attention to the needs of society, including employees, creditors, and communities, as well as shareholders.[4] If owner motivation no longer translated into efficiency from a societal point of view because the corporation was controlled by nonowners, government should intervene to ensure that the corporation is operated in a socially responsible manner.[5]

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2. *Id.*

3. *Id.* at 299-302.

4. *Id.* at 312. While this was Professor Berle's theoretical conclusion in *The Modern Corporation and Private Property*, he maintained in an article written about the same time that, as a practical matter, the corporation should be operated in the sole interest of shareholders, until a "clear and reasonably enforceable scheme of responsibilities to someone else" could be devised. *Berle, For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932). *But see* Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Dodd, *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?*, 2 U. CHI. L. REV. 194 (1934).

5. Professor Dodd also maintained that property rights should be protected only if they benefit society as a whole. He stated that "business is permitted and encouraged by the law primarily because it is of service to the community rather than because it is a source of profits to its owners." Dodd, *For Whom Are Corporate Managers Trustees?*, *supra* note 4, at 1149 (1932). He further maintained that:

> If certain businesses . . . continue to be allowed unregulated profits, it will be as a matter of legislative policy because the lawmakers regard the competitive conditions under which such businesses are carried on as making regulation of profits unnecessary, and not because the owners of such enterprises have any constitutional right to have their property treated as private in the sense in which property held merely for personal use is private.

Id. at 1149. *See also* Berle, *Corporate Decision-Making and Social Control*, 24 BUS. LAW. 149, 150 (1968). *But see* Berle, *supra* note 4, at 1368 ("Either you have a system based on individual ownership of property or you do not.").

Berle and Means could have attacked the traditional ownership model by focusing exclusively on the size and complexity of the modern corporation. Responsibility for and control over corporate operations even by an owner-manager is largely attenuated in such a corporation.[6] Decisions will necessarily be made by nonowners. Indeed, the effect of the separation of share ownership and control becomes less significant as the size and complexity of corporations increase.[7] Nevertheless, Berle and Means concentrated on the separation of ownership and control as the most important factor in the governance of the modern corporation. The focus on separation of ownership and control, rather than the size and complexity of the public corporation, was largely dictated by a simplistic concept of the firm, embodied in the entrepreneurial model, which also underlies the traditional model.

In this entrepreneurial paradigm, the firm is controlled by an all-powerful entrepreneur. The entrepreneur determines firm goals and assures conformity to those goals by making side payments, such as wages to employees, and by instituting a system of internal administrative controls.[8] To Berle and Means, it was the bifurcation of the identity of the entrepreneur into owners and managers that necessitated a reexamination of corporate governance to ensure the social responsibility of the corporation.

The significance of the separation of share ownership and control has largely dominated the corporate law literature since Berle and Means challenged the traditional ownership model. Their work has spawned numerous proposals for reforming cor-

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6. Berle and Means were clearly concerned with actual responsibility and control over corporate property. A. BERLE & G. MEANS, *supra* note 1, at 305; Berle, *supra* note 4, at 1369. They were also concerned with legal responsibility, which is diminished for the owner-manager in a large complex corporation for the simple reason that the owner-manager cannot be expected to take responsibility for all aspects of the corporation's operations.

7. *Cf.* J. GALBRAITH, THE NEW INDUSTRIAL STATE 59-71 (2d ed. 1971) (arguing that organized intelligence or technocrats at middle levels are the brain of the enterprise). *But cf.*, M. EISENBERG, THE STRUCTURE OF THE CORPORATION 164 (1976) (arguing that important policy decisions are made in the office of the Chief Executive). This observation concerning size and complexity may also explain some of the negative findings as to the effect of "owner control" on the performance of public corporations. *See* R. POSNER, ECONOMIC ANALYSIS OF LAW 394 n.1 (3d ed. 1986). Contrary to the understanding of many corporate law scholars, there are reasons why even small firms managed by owners should not provide the standard for efficiency. Owner-managers "may or may not be motivated only by the search for profits" and "may habitually consume on the job." Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J. L. & ECON. 375, 383 (1983). For a discussion of incentives, see *infra* notes 101-54 and accompanying text.

8. R. CYERT & J. MARCH, A BEHAVIORAL THEORY OF THE FIRM 27-28 (1963).

porate governance.[9] Proposals have been made to increase owners' control of the corporation through modifications of the federal proxy rules.[10] Proposals have also been made for greater monitoring of managers and for including independent, public interest, and constituency representatives on boards of directors.[11] At the core of many of these proposals, sometimes as a hidden premise, is the notion that the reforms would not be necessary absent a separation of share ownership and control.[12]

Beginning in the 1960's, law and economics writers began to attack the significance attached by Berle and Means and their progeny to the separation of share ownership and control.[13] The law and economic writers developed a more complex conceptualization of the firm, which I will call the "efficiency model."[14]

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9. *E.g.*, COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE: THE ALI-ABA SYMPOSIUMS 1977-1978 (D. Schwartz ed. 1979); SECURITIES AND EXCHANGE COMMISSION 96TH CONG., 2D SESS., STAFF REPORT ON CORPORATE ACCOUNTABILITY (Comm. Print 1980) [hereinafter SEC ACCOUNTABILITY REPORT]; AMERICAN LAW INSTITUTE, *Principles of Corporate Governance: Analysis and Recommendations; Symposium: Corporate Social Responsibility*, 30 HASTINGS L.J. 1247 (1979); *Symposium on Corporate Governance*, 8 HOFSTRA L. REV. 1 (1979).

10. *E.g.*, SEC ACCOUNTABILITY REPORT, *supra* note 9, at 63-225.

11. *See, e.g.*, M. EISENBERG, THE STRUCTURE OF THE CORPORATION 149-85 (1976); R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION 124-28 (1976); C. STONE, WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR 152-83 (1975); Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099 (1977); Moscow, *The Independent Director*, 28 BUS. LAW. 9 (1972); Solomon, *Restructuring the Corporate Board of Directors: Fond Hope—Faint Promise?*, 76 MICH. L. REV. 581 (1978).

12. Additional bases offered to support various corporate law reform proposals are the concession theory and the principle of affected interests. The concession theory maintains that corporations obtain their authority and privileges (such as limited liability for shareholders) from the government and, therefore, may be regulated in the public interest. *See* Comment, *Broadening the Board: Labor Participation in Corporate Governance*, 34 SW. L.J. 963 (1980); Hessen, *A New Concept of Corporations: A Contractual and Private Property Model*, 30 HASTINGS L.J. 1327 (1979). The principle of affected interest is a democratic concept that maintains that those groups affected by the corporation have a right to be heard. *E.g.*, R. DAHL, AFTER THE REVOLUTION 123 (1970). Corporations affect the public, according to this principle, and thus may be regulated in the public interest.

13. *E.g.*, Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967).

14. In developing the model, I draw upon what is known as the property rights literature [hereinafter the incentive-residual rights approach] and the agency cost literature. *E.g.*, Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375 (1983); Easterbrook & Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986); Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L. J. 698 (1982); Easterbrook & Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395 (1983); Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Fama & Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983); Fama & Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259

In this model, the firm is a "nexus of contracts" or a marketplace where various constituencies contract for their own protection. The entrepreneurial concept of the firm is rejected. Ownership of the firm disappears as a meaningful concept under this model because no one can own a "nexus." Shareholders are merely parties to one contract that comprises the firm. Moreover, control of the firm is shared among various constituencies. Control is reflected in the terms of various contracts entered into by individuals. According to this model, it makes little sense to focus upon shareholders' "ownership" and control when various constituencies share control. It also makes little sense to speak of "corporate" social responsibility because the firm is only a "nexus." Various constituencies can obtain the protection they need by bargaining for contract terms.

Adherents to the efficiency paradigm are less concerned than were Berle and Means with the behavior of nonowner managers, who are described as "agents," constrained by the terms of contracts with various constituencies, or by market forces. While managers have the incentive to "shirk," the costs of their shirking ("agency costs"), to the extent it is cost effective to do so, are decreased by the terms of these contracts. For example, shareholders bargain for their own protection by contracting for certain voting rights, for a board of directors composed of shareholder representatives that will monitor managers, and for the imposition on directors of fiduciary duties to act in the shareholders' best interest. Moreover, shareholders monitor managers through stock trades both by facilitating takeovers, which dis-

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(1982); Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Klein, *Contracting Costs and Residual Claims: The Separation of Ownership and Control*, 26 J.L. & ECON. 367 (1983); Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521 (1982) [hereinafter Klein, *The Modern Business Organization*]; Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977). Where indicated, the transaction cost approach is also discussed. *E.g.*, O. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985) [hereinafter O. WILLIAMSON, CAPITALISM]; O. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975); Williamson, *Corporate Governance*, 93 YALE L.J. 1197 (1984) [hereinafter Williamson, *Corporate Governance*]; Williamson, *The Economics of Organization: The Transaction Cost Approach*, 19 J. ECON. LITERATURE 548 (1981); Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LITERATURE 1537 (1981); Williamson, *Transaction Cost-Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979); Williamson & Ouchi, *The Markets and Hierarchies Program of Research: Origins, Implications, Prospects*, in PERSPECTIVES ON ORGANIZATION DESIGN AND BEHAVIOR 347 (1981) [hereinafter Williamson & Ouchi, *The Markets and Hierarchies*].

place inefficient managers, and by providing necessary information to the labor markets concerning the efficiency of managers.

The separation of share ownership and control, to the extent that it is meaningful to speak of firm "ownership," is efficient for society. Shareholders are able both to obtain the advantages of centralized management by persons with substantial business expertise and to engage in cost-effective monitoring. Various corporate reform proposals that would give shareholders greater control and increase the monitoring of managers would not be efficient, or shareholders or other constituencies would have contracted for these rights. If it were efficient, for example, for the board to assume a more active monitoring role or for independent or constituency directors to be elected to the board, shareholders would contract to do exactly this. The process of natural selection in the marketplace will cause the evolution and survival of those governance arrangements that are most efficient.

While the efficiency model thus represents a more complex concept of the corporation than the traditional ownership model, it rehabilitates the conclusions of the traditional model. It supports existing corporation law by providing that shareholders shall have the rights to elect directors, to vote on certain matters, and to rely on the duty of directors to act in the best interest of shareholders, although it opposes corporate reform proposals that would expand or strengthen these rights. The model also reaffirms the traditional model's notion that these rights should be possessed by shareholders rather than other constituencies. To support their position, adherents of the efficiency model rely upon the natural selection argument mentioned above, as well as two additional arguments. One is the traditional ownership argument that shareholders have profit incentives that ensure the efficient utilization of resources.[15] Unlike the traditional model, however, major emphasis is placed on the effect of the profit incentive on stock trading activities, rather than on actual management of the company. The other argument is that shareholders' investments are purportedly more nonredeployable and firm-specific than those of other constituencies; thus shareholders would not make these investments unless they had these rights.[16]

15. The incentive-residual rights literature makes this argument. This literature is referred to *supra* note 14, and is discussed *infra* text accompanying notes 119-54.

16. This argument is found in the transaction cost literature referred to *supra* note 14 and is discussed *infra* text accompanying notes 174-227.

Because efficiency-model theorists support the efficiency of existing governance arrangements, they oppose legislation that would challenge the shareholder-centered nature of corporate law. They would oppose legislation passed in response to the takeover phenomenon which allows directors to take into account the interests of other constituencies who also have a stake in the enterprise[17] or which otherwise regulates takeovers in the interests of employees and communities.[18] Shareholders seeking profits may properly buy and sell companies like commodities, because society in the end will benefit if shareholders profit.

This Article introduces a new model of corporate governance, which challenges, as did Berle and Means, the conclusions drawn from the traditional ownership model. Rather than focusing upon the inefficiencies of the large complex firm resulting from the separation of share ownership and control, however, this new model, which I call the power model, focuses upon the political nature of decision making in the large corporation, which exists regardless of the identity of the entrepreneur.[19]

Under the power model, the firm is not a "nexus" or marketplace, but an organic institution with its own internal structure and processes that impact on control of the firm. Management is not an "agent," but holds a strategic position in the firm that it utilizes to minimize the influence of other constituencies. Rather

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17. *E.g.*, ME. REV. STAT. ANN. tit. 13-A, § 716 (1987 Supp.); MINN. STAT. ANN. § 302A. 251.5 (West Supp. 1987); MO. REV. ANN. § 351.347(1)(4) (1986); OHIO REV. CODE ANN. § 1701.59(E) (Anderson Supp. 1987); PA. STAT. ANN. tit. 42 § 8363(b) (Purdon Supp. 1986); *see* Newlin & Gilmer, *The Pennsylvania Shareholder Protection Act: A New Approach to Deflecting Corporate Takeover Bids*, 40 BUS. LAW. 111 (1984).

18. Control share acquisition provisions ostensibly intended to protect investors may actually be designed to protect the interests of other constituencies. Johnson, *Minnesota's Control Share Acquisition Statute and the Need for New Judicial Analysis of State Takeover Legislation*, 12 WM. MITCHELL L. REV. 183, 185 (1986).

19. I draw upon a number of sources in the management science and sociological literature to create this model. *See generally* R. BURT, CORPORATE PROFITS AND COOPTATION (1983); R. CYERT & J. MARCH, A BEHAVIORAL THEORY OF THE FIRM (1963); H. MINTZBERG, POWER IN AND AROUND ORGANIZATIONS (1983); C. PERROW, COMPLEX ORGANIZATIONS: A CRITICAL ESSAY (3d ed. 1986); J. PFEFFER, ORGANIZATIONS AND ORGANIZATION THEORY (1982); J. PFEFFER & G. SALANCIK, THE EXTERNAL CONTROL OF ORGANIZATIONS: A RESOURCE DEPENDENCE PERSPECTIVE (1978); W. SCOTT, ORGANIZATIONS: RATIONAL, NATURAL AND OPEN SYSTEMS (1981); W. SCOTT, T. MITCHELL & P. BIRNBAUM, ORGANIZATION THEORY: A STRUCTURAL AND BEHAVIORAL ANALYSIS (1981); P. SELZNICK, TVA AND THE GRASS ROOTS: A STUDY IN THE SOCIOLOGY OF FORMAL ORGANIZATION (1966); J. THOMPSON, ORGANIZATIONS IN ACTION (1967); Hickson, Astley, Butler & Wilson, *Organization as Power*, 3 RES. ORGANIZATIONAL BEHAV. 151 (1981); Hickson, Hinings, Lee, Schneck & Pennings, *A Strategic Contingencies' Theory of Intraorganizational Power*, 16 ADMIN. SCI. Q. 216 (1971); Meyer & Rowan, *Institutionalized Organizations: Formal Structure as Myth and Ceremony*, 83 AM. J. SOC. 340 (1977); Jacobs, *Dependency and Vulnerability: An Exchange Approach to the Control of Organizations*, 19 ADMIN. SCI. Q. 45 (1974).

than being merely a facility for exchange, the firm is very much an actor in its environment that seeks to increase its discretion and autonomy by decreasing its dependence on various constituencies. It has various strategies that it utilizes to decrease their influence. The firm is not merely responsive to an environment but acts to modify that environment. Control of the firm can be understood in terms of power coalitions bargaining with one another, not freely, but in the context of social, historical, and political relationships (often determined by legal rules). Control arrangements in the firm ultimately reflect cultural and political values that are reflected in the reality that firms have created and with which in turn they must deal. Under the power model, property rights and, hence, shareholder voting rights, are not understood on the basis of efficiency considerations but are understood as resulting from a number of historical, cultural, and political forces.

As this Article will demonstrate, arguments upon which the efficiency model relies concerning natural selection, shareholder incentives, and the firm-specific nature of shareholder investments are largely outcome determinative, intended to justify, on a supposedly objective basis, the status quo and existing power arrangements. The validity of the efficiency paradigm is unconvincing because it rests on ambiguous terminology, unsupported assumptions about human motivation, and the summation of various costs and benefits. Virtually any control arrangement can be rationalized if enough cost, benefit, and incentive factors are taken into account, because there is no way to weigh any of these variables. Moreover, because the status quo can be explained on the basis of power considerations, there is no reason to presume that that which exists is efficient. Indeed, power is a better explicator of the real world. Principles based on the efficiency model—that shareholders should elect board members and that managers owe fiduciary duties to shareholders—appear, under the conceptual lens of the power model, to be legitimizing myths ensuring the political acceptability of power wielded by managers.[20]

Because the power model rejects the efficiency model's presumption that existing control arrangements are efficient, the important questions to ask in connection with any corporate or market phenomena become who benefits and who loses or, in terms of efficiency, "efficient for whom?" and "at what costs to others?" Governments are justified in asking these questions

20. *See infra* text accompanying notes 228-307.

and reaching conclusions. The burden is not on governments to justify their conclusions, as the efficiency theorists argue, but on those opposing them, because what exists in the private sector is not necessarily more efficient from a societal perspective.[21] Any assessment of corporate or market phenomena, such as takeovers, must be understood as involving values and judgments, rather than the pseudoscientific application of formulas and "evolutionary" theories.

The model of the corporation that is used by corporate law scholars, whether consciously or unconsciously, is extremely important. It tends to determine upon what aspects of corporate governance writers will concentrate. For example, Berle and Means, viewing the world with the entrepreneurial model, focused upon the bifurcation of the identity of the entrepreneur, the separation of share ownership from control. Law and economics writers, conceiving of the firm as a nexus of contracts, have focused upon the many constraints on managerial behavior. They have strived to explain relationships of various constituencies with the firm as resulting from contract bargaining where contract terms necessarily provide for the protection of private parties in cost-effective ways. Using the power model, this Article focuses on sources of power, power strategies, and the extent to which relationships are embedded in an historical, cultural, and political context. Each of these models has implications for the evaluation of existing corporate law and corporate reform proposals.

Because of the importance of models, this Article is devoted to the development and analysis of the efficiency and power models. Writers who are critical of the efficiency model, which has come to dominate corporate law thinking, have been hampered by the lack of a clear and thorough explication of this model and by the absence of an alternative model. This Article attempts to correct these two failings.

Rather than developing each model completely and then comparing them in a final section, I have divided this Article into

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21. Even if one were to accept the interest group theory of legislation, ideological and structural factors operate in the public sector that serve to limit deviance from public-regarding legislation. *E.g.*, Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 240 (1986) ("The very presence of an independent judiciary serves as an inevitable and legitimate obstacle to the interest group's objectives"). *But see* Easterbrook, *The Supreme Court, 1983 Term—Foreword: The Court and the Economic System*, 98 HARV. L. REV. 4 (1984); Landes & Posner, *The Independent Judiciary in an Interest-Group Perspective*, 18 J.L. & ECON. 875, 894 (1975) (stating that the independent judiciary enforces the deals made by interest groups).

four parts, which address different aspects of the models. The parts are entitled: (I) The Firm, (II) Management, (III) Firm Objectives, and (IV) Firm Behavioral Determinants, the Shareholder-Management Relationship, and the Board of Directors. In each part, the efficiency and power models are discussed separately and then compared. This order has been adopted to highlight most effectively the differences and the similarities in the models. However, the reader should read all parts to understand the models fully, because each part covers only one aspect of the models, and there is necessarily some judgment used in allocating material among these parts to avoid repetition.

Part I focuses upon the general description of the firm offered by each model. Because conceptual lenses are being created, particular attention is given to the language or terms used to describe the corporation and the connotations or associations they suggest. Under the efficiency model, for example, the firm is a "nexus of contracts" and, therefore, disappears as an actor, making questions as to "corporate" responsibility meaningless. This conceptualization is unlike that of the power model, which represents the corporation as an institution dominated by certain power coalitions who are furthering their goals through that institution. Under this paradigm, questions concerning "corporate" responsibility or to whom the corporation should be responsible become important.

Part II discusses management from the perspectives of the two models. The use of the word "agents" is central to the efficiency model's characterization of managers as instruments implementing shareholder objectives subject to the discipline of markets. The power model, in contrast, develops a different picture of the role of managers, making use of the term "agents" inappropriate.

Part III explores firm objectives from both a positive and a normative perspective. Profit maximization increases the probability of survival of firms and is desirable under the efficiency model. The power model, on the other hand, suggests that firms generally seek to increase their power and autonomy, that firms pursue numerous, often inconsistent goals (other than profit) that increase the adaptability of those firms to changing conditions, and that the profit maximization goal is not neutral but imports value premises in favor of certain groups.

Part IV develops and analyzes each model's explication of firm behavior, the shareholder-management relationship, and the board of directors. The efficiency model explains corporate behavior as resulting from the operation of markets, and de-

scribes governance arrangements in efficiency terms. The management-shareholder relationship is represented as a contractual arrangement, with the board of directors performing a monitoring role over managers. In contrast, under the power model, corporate behavior results from a number of power considerations. This model explains the existence of governance structures in a number of ways other than on the basis of some notion of allocative efficiency. It defines the shareholder-management relationship in political terms with the board of directors serving as a tool of management. The table below outlines features of the two models of corporate behavior that are described and compared in Parts I through IV.

	Efficiency Model	Power Model
Firm	nexus of contracts/ reactive to environment	power coalitions/ proactive with respect to its environment
Management	agent	dominant coalition member
Firm objectives	profit maximization; cost minimization	multiple inconsistent goals; increasing autonomy and discretion
Determinants of structure and behavior	competition in markets	various sources of power
Management/ shareholder relationship	contract	co-optation
Board of directors	"monitoring" device	"tool" of internal coalition

Part V concludes the Article with a reexamination of basic principles of corporate law using the two models.

I. The Firm

A. *Efficiency Model*

According to the efficiency model, the firm is a legal fiction, serving as a "nexus for a set of contracting relationships" among individuals, such as shareholders, employees, customers, and suppliers.[22] Under this "nexus of contract" concept, the firm is merely a facility for exchange, not unlike a stock market.

> [The firm] is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals . . . are brought into equilibrium within a framework of contractual relations. In this sense the "behavior" of the firm is like the behavior of a market; i.e., the outcome of a complex equilibrium process. We seldom fall into the trap of characterizing the wheat or stock market as an individual, but we often make this error by thinking about organizations as though they were persons with motivations and intentions.[23]

The firm is conceptualized as an extension of the market where persons freely and voluntarily enter into contracts specifying the terms of their relationships. The firm itself disappears as an actor and is largely reactive. It thus makes no sense to ask such questions as "what should be the objectives of the firm?" or "does the firm have social responsibility?" Under this model the "firm is not an individual,"[24] it is a market.

B. *The Power Model*

The power model depicts the firm as an institution with its own internal structure that seeks to decrease its uncertainty by increasing its own autonomy and discretion over its environ-

22. Alchian & Demsetz, *supra* note 14, at 778; Fama, *supra* note 14, at 291; Fischel, *supra* note 14, at 1262; Jensen & Meckling, *supra* note 14, at 310.
23. Jensen & Meckling, *supra* note 14, at 311.
24. *Id.; accord* Fischel, *supra* note 14, at 1273 ("Since it is a legal fiction, a corporation is incapable of having social or moral obligations much in the same way that inanimate objects are incapable of having these obligations."). Nonetheless, as discussed in Part III, the efficiency model maintains that firms "should" maximize profits or minimize costs to ensure their survival.

ment.[25] Unlike a wheat market, it utilizes various strategies to decrease its dependence on its environment,[26] thus muting the effects of market constraints. According to the power model, not "only are organizations [perceived as] constrained by the political, legal, and economic environment, but, in fact, law, legitimacy, political outcomes, and economic climate [are understood to] reflect, in part, actions taken by organizations to modify these environmental components for their interests of survival and growth."[27] Thus, the firm is not merely reactive with respect to its environment, but proactive.

Firm behavior results from a contest for control among power coalitions comprised of groups of individuals in specific relationships to the firm and with each other.[28] Power derives from numerous sources; these are discussed in Part IV. The important bargaining takes place in the context of political and social relationships among groups rather than through individual or atomistic exchanges. The objective is to become part of the dominant coalition, which generally consists of management and some other group, depending on the decision involved and the power of various groups.[29] "Internal" coalitions consist of top management and employees of various divisions and departments. "External" coalitions include shareholders, customers, and suppliers.

Under the power model, the dominant coalition emerges as "the firm,"[30] thus the corporation does not disappear as an actor. The most important question becomes not "what is the objective of the firm?" but "who is in the dominant coalition?"

C. *Discussion and Comparison of Models*

The "nexus of contract" concept of the firm generally obscures the power and authority present in various relationships. An example of the extent to which some efficiency writers ignore

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25. *See infra* text accompanying notes 228-316.

26. *See infra* text accompanying notes 247-307.

27. J. PFEFFER & G. SALANCIK, *supra* note 19, at 108; *accord* C. PERROW, *supra* note 19, at 212-14.

28. *E.g.*, R. CYERT & J. MARCH, *supra* note 19; H. MINTZBERG, *supra* note 19; J. PFEFFER & G. SALANCIK, *supra* note 19; W. SCOTT, *supra* note 19. This Article adopts the term "coalitions" in the plural sense used by Professor Scott. *Id.* at 264. *Accord* Tomlinson, *Economic and Sociological Theories of the Enterprise and Industrial Democracy*, 35 BRIT. J. OF SOC. 591, 602 (1984) (conceptualizing firms as "conglomerates of arenas of struggle").

29. *E.g.*, W. SCOTT, *supra* note 19, at 264-65.

30. *Id.*

power relationships is found in the description of an employer's assignment of employees to different tasks. The reassignment is described as a "renegotiation" of a contract, rather than as the exercise of "authority and direction."[31]

In contrast, concepts of power and authority are integral to the power model. Contracts are merely one of a number of sources of power in the firm, and are themselves a result of power bargaining. In addition, power struggles within the firm are continuous. While it is true that contracts may include ex post governance structures, whether these structures will be put into place and how they will actually operate are largely dependent on power considerations.

The concept of the corporation that is adopted is important because it encourages certain perceptions and excludes others that might otherwise guide actions. The "nexus of contract" formulation of the firm brings to mind the image of persons voluntarily entering into contracts in a competitive market.[32] Emphasis is placed on the voluntariness of exchange relationships and the degree to which individuals can obtain safeguards to protect their interests. Visions of reaching pareto optimal solutions without governmental intervention arise with this description of the firm.[33]

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31. Alchian & Demsetz, *supra* note 14, at 777. This description of the employment relationship has been criticized as obscuring the asymmetrical nature of that relationship. C. PERROW, *supra* note 19, at 226-27; Putterman, *On Some Recent Explanations of Why Capital Hires Labor*, 22 ECON. INQUIRY 171, 175 (1984); *see also* C. PERROW, *supra* note 19, at 230.

32. Note, however, that actual bargaining is not required by various contract models, because the market is relied upon to produce offers in response to the demands of consumers. *E.g.*, Klein, *The Modern Business Organization*, *supra* note 14, at 1522. In proposing his "series of bargains" model, Professor Klein states, "[T]he theory developed here does not necessarily assume that people engage in bargaining. Indeed, if one balks at this notion, one can think in terms of a bargain (an outcome) rather than bargaining (a process)." *See also*, Hetherington, *Redefining the Task of Corporation Law*, 19 U.S.F.L. REV. 229, 256 (1985) ("[T]he fact that individual investors cannot bargain over the provisions of a specific issue is unimportant as long as the market gives issuers an incentive to offer investment packages that investors will buy.").

33. A pareto optimal transaction is one that makes one individual better off without making some other individual worse off, based on each individual's subjective evaluation of his own welfare. P. SAMUELSON, ECONOMICS 460 n.12 (9th ed. 1973). It appears that if two individuals agree to contract, both individuals are better off than if they did not contract. However, a pareto optimal transaction has not necessarily occurred because the new contract may change the terms of a prior contract. These changes may make one of the parties worse off. In addition, the contract may change other preexisting relationships by, for example, excluding someone else from contracting with a party. Also, the implementation of contractual terms may have adverse effects on third parties. Some writers use a modified version of pareto superiority, known as the Kaldor-Hicks formulation. This formulation of efficiency only requires that the transaction increase net social welfare and is unconcerned with its distribution. R. POSNER, *supra* note 7, at 13-14. It is

In contrast, once the power model introduces authority and power into the conceptual framework, the degree to which consent is fictitious in, for example, the context of a contractual relationship or the structure of decision making in the firm become matters for regulatory concern. The difference in the concepts of the firm is also reflected in the vision of the firm as it interacts with its "environment." The firm appears essentially benign with the efficiency model, whereas with the power model it does not. According to the efficiency model, the firm merely reacts to market forces. According to the power model, the firm acts to increase its power over its environment.[34] With the power model, the firm itself is a formidable social and political institution that shapes society rather than merely being shaped by it.

II. MANAGEMENT

A. *Efficiency Model*

Management is an "agent" for various constituencies,[35] such as shareholders, employees, and customers, although some writers believe that management is an agent only for shareholders.[36] The perception of management as an agent is reinforced by the efficiency model's emphasis on the constraining forces of various markets.

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sometimes referred to as wealth maximization. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication,* 8 HOFSTRA L. REV. 487 (1980). Wealth maximization suffers from many of the same ethical and political objections directed at utilitarianism. *E.g.,* Dworkin, *Why Efficiency?,* 8 HOFSTRA L. REV. 563, 574-84 (1980); Kornhauser, *A Guide to the Perplexed Claims of Efficiency in the Law,* 8 HOFSTRA L. REV. 591, 599-600 (1980).

34. *See infra* text accompanying notes 228-316.

35. Alchian & Demsetz, *supra* note 14, at 778 (describing management as the "central contracting agent"); Jensen & Meckling, *supra* note 14, at 310.

36. *E.g.,* Fischel, *supra* note 14, at 1262. Not all theorists whose writings fall within the efficiency model agree with this characterization of management. Professor Klein criticizes the use of agency terminology and emphasizes the legitimate interests of management in control. *See infra* notes 151-53 and accompanying text. Professor Williamson, who adopts the transaction cost approach discussed later in this article, describes management as a "constituency" of the company. O. WILLIAMSON, CAPITALISM, *supra* note 14, at 312-14.

B. Power Model

In the power model, management is a power coalition,[37] which, due to its strategic position in the firm,[38] is usually part of the controlling coalition.

C. Management: Not An Agent

When the term "agent" is given its proper legal meaning, management is not an "agent" for employees, customers, or creditors. The source of the confusion with the efficiency model appears to stem from a frequently cited article that broadly defines agency as "a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent."[39] According to this definition, whenever a person does not perform a service herself and engages in a barter transaction, she has "delegated" decision-making authority to another. Under this definition, all contractual relationships become agency relationships.

Key elements in a true agency relationship are the principal's control over the agent and the agent's obligation to act in the principal's interest. An employer often favors an agency relationship, not because he wants to delegate "decision-making authority to another," but because he wants to retain decision-making authority over the actions of the agent.[40] "Agency," properly understood, is a fiduciary relationship characterized by a promise by the agent to the principal: (1) to act on her behalf and (2) subject to her control.[41] Under this definition, managers

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37. *See supra* note 28.

38. Management has access to external coalitions and is centrally located to obtain information concerning the company. Moreover, it has formal authority over employees.

39. Jensen & Meckling, *supra* note 14, at 308.

40. The control by the principal and the fact that the agent has undertaken to act in the principal's interest also explain other legal characteristics of this relationship, the liability of the principal for the actions of the agent, and the fiduciary obligations of the agent to the principal. The liability of the principal for the actions of the agent logically flows from the control exercised by the principal and the fact that the agent is acting to further the principal's business. Note that the fiduciary obligation does not appear to arise from the principal's liability for the actions of the agent as has been asserted. *See* Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 760 (1978). For example, a trustee owes a fiduciary duty to beneficiaries of a trust, RESTATEMENT (SECOND) OF TRUSTS § 2 (1954), but the beneficiaries are not liable for the actions of the trustee.

41. RESTATEMENT (SECOND) OF AGENCY § 1 (1957).

are not agents for employees, customers, or creditors. Managers are not subject to the continuous and active control of employees, customers, or creditors.[42] Moreover, they do not owe these persons a fiduciary duty to act in their best interests. Under the efficiency model, failure to distinguish between the true agency relationship and other kinds of contractual relationships obscures the authority and control aspects of the agency relationship.[43]

As corporate law scholars are well aware, managers are also not agents for shareholders. Although managers owe fiduciary duties to shareholders, they are not subject to the continuous and active control of shareholders.[44] In fact, state corporation statutes grant independent authority to the board of directors to manage the corporation.[45] The rights of shareholders over managers are limited. Although shareholders can vote for directors,[46] they can nominate them only if they are willing to incur substantial expenses. Shareholders may fill vacancies on the board, but only under certain circumstances.[47] In addition, they may vote on board-initiated proposals only with respect to certain

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> The agent differs from most other fiduciaries such as executors, trustees, etc., in that he remains under the continuous control of the principal as to matters relating to the object of his agency, throughout the entire period of his agency. The agent has a duty, at all times, to obey the directions of his principal, even though the principal may have initially indicated he would not give such additional instructions.

W. SELL, AGENCY 2 (1975).

43. This tendency on the part of the efficiency model has been noted previously. *See supra* text accompanying note 31.

44. RESTATEMENT (SECOND) OF AGENCY § 14C (1957); *see* W. SELL, *supra* note 42, at 20.

45. *E.g.*, CAL. CORP. CODE § 300 (West 1984); DEL. CODE ANN. tit. 8, § 141 (1983); REVISED MODEL BUSINESS CORP. ACT. § 8.01(b) (1984). Under certain circumstances, shareholders may determine corporate policy through shareholder agreements and/or by electing special status for the corporation under state statutes primarily applicable to close corporations. These statutes provide for the enforceability of shareholder agreements under certain circumstances, and some statutes permit shareholders to dispense with a board of directors. *See, e.g.*, DEL. CODE ANN. tit. 8, § 351 (1983); N.Y. BUS. CORP. LAW § 620 (McKinney 1986).

46. *E.g.*, CAL. CORP. CODE § 301 (West 1984); DEL. CODE ANN. tit. 8, §§ 151(a), 211(b) (1983); REVISED MODEL BUSINESS CORP. ACT § 8.03(d) (1984). In some states, debtholders may elect directors if the company's charter so provides. *E.g.*, DEL. CODE ANN. tit. 8, § 221 (1983); CAL. CORP. CODE § 204(a)(7) (West Supp. 1987). Employees may elect directors if the charter so provides under Massachusetts corporation law. MASS. GEN. LAWS ANN. ch. 156, § 23 (West 1986).

47. *E.g.*, CAL. CORP. CODE § 305 (West 1984 & Supp. 1987); DEL. CODE ANN. tit. 8, § 223 (1983).

fundamental changes.[48] Finally, most shareholder proposals permitted under federal proxy rules must be in the form of "recommendations" to the board.[49] These powers fall far short of the control exercised by principals over agents in an agency relationship. Therefore, the use of the term "agent" in the efficiency model serves to overstate control by shareholders over the actions of management.[50]

In the power model, management is a power coalition. This is an appropriate description of management's role, because it recognizes management's independent statutory source of power. Management has the right to make various decisions concerning the corporation granted by state corporation statutes. As a fiduciary for shareholders, it is true that these decisions must be made in the best interests of shareholders. Management, however, has the right to decide for shareholders what is in their best interests. These judgments are subject to control only by courts, which grant managers considerable flexibility.[51]

The efficiency model incorrectly uses legal terminology to describe the role of management that emphasizes control over management. In contrast, the power model underlines management's uniquely controlling position in the firm.

III. FIRM OBJECTIVES

The efficiency and power models differ in their depiction of management and result in differing perceptions of the autonomy and power that corporate managers possess. The two models also suggest different conclusions concerning firm objectives and the efficiency of existing governance structures. The efficiency

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48. *E.g.*, CAL. CORP. CODE §§ 903, 1001, 1103, 1201, 1903 (West 1984 & Supp. 1987); DEL. CODE. ANN. tit. 8, §§ 151, 242, 251, 271, 275 (1983); REVISED MODEL BUSINESS CORP. ACT §§ 10.03, 11.03, 12.02, 14.02 (1984).

49. Auer v. Dressel, 306 N.Y. 427, 118 N.E.2d 590 (1954); Adoption of Amendments Related to Proposals by Security Holders, Exchange Act Release No. 12,999 (LEXIS, Fedsec library, Secrel file) (Nov. 22, 1976).

50. Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1428 (1985); Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (1985). Use of the term "agency" to describe contracts by management with customers, suppliers, and creditors also serves to understate unique aspects of the shareholder-management relationship in which shareholders have ongoing participatory rights in the governance of the corporation. Use of a single term to describe all such relationships obscures the privilege that state corporation laws grant to shareholders as a power coalition to vote for representatives to an ongoing governing body of the corporation, the board of directors.

51. *See infra* text accompanying notes 340-41.

model posits that firms in the aggregate maximize profits and should pursue that objective. For support, it draws upon the natural selection argument that maintains that only the most profitable firms survive. In contrast, the power model suggests that firms seek to increase their power and autonomy, which is not necessarily synonymous with the quest for profits. According to the power model, profit seeking fulfills the goals of some coalitions, but not others. The power model challenges the conclusions of the efficiency model and its foundations, such as the natural selection argument. This Section explicates and evaluates these perspectives.

Adherents of the efficiency model maintain that the profit maximizing goal has positive and normative implications. From a positive perspective, they argue that firms in the aggregate act as though they were maximizing profits. Firms that maximize profits are said to utilize resources efficiently and, therefore, maximize their chances of survival. It presumably follows that those firms that survive do so because they are more efficiently structured and operated than other firms that fail or hypothetical firms structured or operated in different ways. Therefore, existing governance structures (such as boards composed of shareholder representatives and hierarchical work organization) can be explained on the basis of efficiency considerations. From a normative perspective, the efficiency model indicates that firms should maximize profits to increase both efficiency and the probability of survival of the firm, that corporations should set goals to benefit shareholders, whose interests are presumably consistent with profit maximization, and that government should not interfere with existing governance structures because they have been selected by markets as having efficient survival properties.

The power model, in contrast, rejects profit maximization from both a positive and normative standpoint. From a positive perspective, firms behave as though they were seeking to decrease their dependence on their environment in order to increase their autonomy and discretion. The actions of firms in pursuit of power may or may not be consistent with some notion of allocative efficiency, because firms seek to insulate themselves from market demands and to affect the operation of markets. The power paradigm posits that governance structures of firms can be explained more persuasively on the basis of a number of factors other than efficiency. From a normative perspective, profit maximization involves value choices favoring certain

groups. In addition, firms pursuing numerous, often inconsistent, goals adapt better to changing conditions.

A. *Efficiency Model*

Profit maximization and cost minimization are associated with the efficiency model. Supposedly, profit maximization can be assumed and need not be proven.[52] The profit maximization assumption is purportedly buttressed by a "natural selection" argument that asserts that only firms that maximize profits will survive.[53] According to this argument, firms need not intend to maximize profits; only those firms that actually make profit-maximizing decisions will survive.

Some law and economics writers rely upon a weaker version of the natural selection argument.[54] This version replaces the notion that only firms that maximize profits survive with the position that firms with the highest profits in the marketplace have the highest probability of survival.[55]

The efficiency model also embraces another school of thought, referred to as the "transaction cost approach,"[56] which focuses on particular transactions rather than the behavior of firms in the aggregate. The transaction cost approach maintains that, within the limits of "bounded rationality,"[57] firms act to mini-

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52. *See* M. FRIEDMAN, ESSAYS IN POSITIVE ECONOMICS (1953); Jensen, *Organization Theory and Methodology*, 50 ACCT. REV. 319 (1983). Profit maximization is used as an assumption to predict the aggregate behavior of firms responding to market conditions.

53. Milton Friedman explains:

> [U]nless the behavior of businessmen in some way or other approximated behavior consistent with the maximization of returns, it seems unlikely that they would remain in business for long. Let the apparent immediate determinant of business behavior be anything at all. . . . Whenever this determinant happens to lead to behavior consistent with rational and informed maximization of returns, the business will prosper and acquire resources with which to expand; whenever it does not, the business will tend to lose resources and can be kept in existence only by the addition of resources from outside. The process of "natural selection" thus helps to validate . . . the [profit maximization] hypothesis—or rather, given natural selection, acceptance of the hypothesis can be based largely on the judgment that it summarizes appropriately the conditions for survival.

M. FRIEDMAN, *supra* note 52, at 22.

54. *See* Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211 (1950); Fama & Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301 n.1 (1983).

55. As with the stronger version of the argument, profits may be made through luck or irrational decision making.

56. O. WILLIAMSON, CAPITALISM, *supra* note 14, at 15; *see* Williamson, *Corporate Governance*, *supra* note 14. *See generally supra* note 14.

57. *See infra* note 175.

mize transaction costs. The notion of bounded rationality means that the firm will act so as to minimize transaction or contracting costs within the limits of the cognitive abilities of its agents. Super-rationality, often associated with the profit-maximization assumption (but not by the natural selection arguments), is not required by this approach. Unlike the approach found in the natural selection arguments, the transaction cost approach assumes firms minimize costs intentionally.[58]

The transaction cost approach is similar to the natural selection theory in maintaining that governance relationships that persist over a period of time, say a decade, are presumed to be efficient.[59] Common to the natural selection and transaction cost approaches is the notion that competition or natural forces will ultimately "select" the most efficient firms and governance structures. Those structures that are efficient are those most responsive to the demands of the environment and the multiple goals of the constituencies with which the firm must deal.

It is desirable under the efficiency model that management organize the demands on the firm into some sort of a preference function that protects the firm from multipeaked preferences and inconsistent goals.[60] Rationality is achieved. Employees are paid wages to adopt the goals of the firms. A distinction is made between goals such as wages (side payments) that motivate employees to accept organizational roles, and goals that employees consider after having assumed those roles.[61]

B. *Power Model*

According to the power model, the firm acts to decrease the uncertainty of its environment by increasing its power over, and

58. O. WILLIAMSON, CAPITALISM, supra note 14, at 45-46.

59. Williamson & Ouchi, *The Markets and Hierarchies, supra* note 14, at 363-64.

60. Fischel, *supra* note 14, at 1262. The reference to peaks may be a reference to the work of Andreas Papandreou, who maintained that multiple goals were imposed upon the organization by various participants and that they passed through a Peak Coordinator, who integrated them into a single preference function. His contribution was noteworthy at the time for finding a way to retain the maximization assumption while abandoning the single profit maximization goal for the firm. Papandreou, *Some Basic Problems in the Theory of the Firm,* in 2 A SURVEY OF CONTEMPORARY ECONOMICS 183 (B. Haley ed. 1952); *see* H. MINTZBERG, *supra* note 19, at 12-14.

61. *Cf.* H. SIMON, ADMINISTRATIVE BEHAVIOR 277 (1976) (stating that organizational goals are associated with the employee's organizational role and are only indirectly related to the personal motives of the individual in that role).

autonomy from, its environment.[62] This may be viewed as a general corporate goal because it consistently emerges as an objective or an intended outcome of corporate actions and decisions.[63] The corporation utilizes various strategies to achieve these ends, which will be pursued at the expense of profit, although subject to a profit constraint.[64]

In the power model the survival of governance structures can be explained in a number of ways other than on the basis of their profit-maximizing or cost-minimization attributes.[65] They may be perpetuated: (1) because they are demanded by those in positions of power;[66] (2) because they have become the traditional or accepted way of doing things;[67] (3) because changing structures would require the adoption of values not reinforced

62. *See supra* text accompanying notes 25-27 and *infra* text accompanying notes 228-316.

63. Two primary characteristics of corporate goals, according to Professor Mintzberg, are consistency and intendedness. "[T]o the extent that there is some consistency in the intentions behind the decisions and actions taken by [the corporation's] participants, the organization as a system can be said to pursue a certain outcome consistently." H. MINTZBERG, *supra* note 19, at 246. Professor Mintzberg identifies "systems goals" as meeting these characteristics, which include the following: "first, survival; second, a certain level of efficiency to ensure survival; third, control of the organization's environment to ensure an adequate degree of independence . . . and fourth . . . growth." *Id.* at 247. Professor Mintzberg maintains that the goals of survival, profit, control, and growth represent a hierarchy of organizational goals; the goals relate to the organization's stages of development. He states "most often, survival, efficiency, and control seem to be treated as constraints, goals subordinate to growth, the most common primary goal of the system called organization." *Id.* at 278. This model is analogous to Maslow's needs hierarchy for individuals. D. HELLRIEGEL, J. SLOCUM & R. WOODMAN, ORGANIZATIONAL BEHAVIOR 359-62 (3d ed. 1983).

64. *See infra* text accompanying notes 247-307. These strategies of power maintenance and acquisition introduce into the power model a degree of organizational level rationality, although somewhat less than the transaction cost approach. The natural selection arguments by themselves do not require attention to internal decision-making processes as do the power model and transaction cost approaches.

65. It may be inefficient to correct an earlier decision which in the current environment results in an inefficient governance structure. That is, transaction costs or sunk investments may make changes to a more efficient arrangement inefficient.

66. *E.g.*, C. PERROW, *supra* note 19, at 208-18; J. PFEFFER & G. SALANCIK, *supra* note 19, at 23, 189-90, 234-35, 277 ("power is one important variable intervening between environments and organizations"); W. SCOTT, *supra* note 19, at 155, 158, 230-32, 253-54; Perrow, *Comment on Langton's "Ecological Theory of Bureaucracy,"* 30 ADMIN. SCI. Q. 278, 279 (1985); *see also* Bowles & Gintis, *The Marxian Theory of Value and Heterogeneous Labour: A Critique and Reformulation*, 1 CAMBRIDGE J. OF ECON. 173 (1977); Reich & Devine, *The Microeconomics of Conflict and Hierarchy in Capitalist Production*, 12 REV. RADICAL POL. ECON. 27 (1981) (arguing that the nature of the political-economic system, not technology or information and transaction costs, affects governance structures). See *infra* text accompanying notes 312-14 on the enactment process. *Cf.* Putterman, *supra* note 31, at 186.

67. *E.g.*, J. PFEFFER, *supra* note 19, at 190, 239-41; W. SCOTT, *supra* note 19, at 141, 158; Meyer & Rowan, *supra* note 19, at 343.

by existing structures that tend to generate their own value system;[68] or (4) because they are buffered from the effects of competition.[69]

In the power model, it is the intentions of the dominant coalition with respect to particular decisions[70] that determine specific firm goals. The aspirations of the dominant coalition define the goals.[71] Firm goals result from continuous bargaining among co-

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68. *E.g.*, E. FROMM, THE SANE SOCIETY (1955); J. PFEFFER, *supra* note 19, at 190; Davis, *A Critique of the Ideology of Efficiency*, 12 HUMBOLDT J. SOC. REL. 73, 80-84 (1985).

69. *E.g.*, J. PFEFFER, *supra* note 19, at 186-87; W. SCOTT, *supra* note 19, at 158.

70. Some writers express the difficulty of dealing with organizational goals without, on the one hand, reifying the corporation or granting it anthropomorphic properties or, on the other hand, defining those goals as the aggregation of goals of individuals comprising the organization. R. CYERT & J. MARCH, *supra* note 19, at 26; Simon, *On the Concept of Organizational Goal*, 9 ADMIN. SCI. Q. 1 (1964). The concept of the dominant coalition resolves aspects of this problem. As explained by Professor Scott:

> * The problem of reification is avoided: individuals and groups have interests, and the process by which these preferences come to be imposed on the organization is specified.
>
> * Although individuals are allowed to specify the goals of the organization, there is no presumption that they do so on an equal footing, nor is it assumed that individual participants hold common objectives.
>
> * Although individuals impose goals on the organization, in most cases no single individual is powerful enough to determine completely the organization's goals; hence, the organization's goals are distinct from those of any of its participants.
>
> * Allowance is made for the presence of differences in interests among participants; some, but not all, of these differences may be resolved by negotiation, so at any time, conflicting goals may be present.
>
> * It is recognized that the size and composition of the dominant coalition may vary from one organization to another and within the same organization from time to time.

W. SCOTT, *supra* note 19, at 265.

71. Goals, rather than being maximized, are in the form of aspiration levels. Aspiration levels are generally a function of experience (or the achievement of the firm) and the side payments received by other coalitions comprising the firm. R. CYERT & J. MARCH, *supra* note 19, at 34. This description is consistent with the equity theory of human motivation that maintains that individuals compare their situation with that of others and behave accordingly. *E.g.*, D. HELLRIEGEL, J. SLOCUM & R. WOODMAN, *supra* note 63, at 379-82; Campbell & Pritchard, *Motivation Theory in Industrial and Organizational Psychology*, in HANDBOOK OF INDUSTRIAL AND ORGANIZATIONAL PSYCHOLOGY 63, 104-05 (M. Dunnette ed. 1983). There is often a discrepancy between aspiration levels and the actual operations of the firm with aspirations lagging behind the firm's performance in good times and ahead of the firm's performance in bad times. R. CYERT & J. MARCH, *supra* note 19, at 34. This discrepancy is referred to as organizational slack. To Professor Mintzberg, slack is that "surplus which is kept in the organization itself, not paid to influencers." H. MINTZBERG, *supra* note 19, at 252 n.5. Professors Cyert and March assume that it is distributed to various coalitions, although organizational slack is not necessarily the subject of general bargaining, because it does not involve "allocation in the face of scarcity." R. CYERT & J. MARCH, *supra* note 19, at 37. Those with the best access to information concerning the location of slack are able to obtain more of it. *Id.* The stabilizing effects of organizational slack, however, can be better understood with Professor Mintzberg's definition. The mechanization of stabilization is that "(1) by absorbing

alitions through regularized channels with respect to the various activities of the firm.[72] The firm itself may also generate goals necessary to its survival.[73]

In the power model the firm is characterized by a fair amount of unresolved conflict.[74] Multipeaked preferences are an everyday reality for the firm, which is comprised of diverse elements. Like any political institution (though one that must balance its budget), it cannot expect to resolve all differences; firm goals are inconsistent.[75] The firm may decide to improve the health of its workers by providing health benefits at the same time that it

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excess resources, [organizational slack] retards upward adjustment of aspirations [goals] during relatively good times; (2) by providing a pool of emergency resources, it permits aspirations to be maintained (and achieved) during relatively bad times." R. CYERT & J. MARCH, *supra* note 19, at 38. While too much slack can be harmful, W. SCOTT, *supra* note 19, at 216, its stabilizing effect is arguably beneficial:

> Resource scarcity brings on renewed bargaining and tends to cut heavily into the excess payments introduced during plush times. . . . More important, the cushion provided by organizational slack permits firms to survive in the face of adversity. Under the pressure of a failure (or impending failure) to meet some set of demands on the coalition, the organization discovers some previously unrecognized opportunities for increasing the total resources available.

R. CYERT & J. MARCH, *supra* note 19, at 38.

72. *See* R. CYERT & J. MARCH, *supra* note 19, at 28, 33. Stability in the system may be explained by organizational processes, such as budgets, hierarchical or cyclical attention to goals, H. MINTZBERG, *supra* note 19, at 261-62, and other factors discussed *supra* text accompanying notes 66-69.

73. The emergence of new goals from the organization of the firm itself is consistent with the dominant coalition approach. Professor Scott explains:

> Although interests are certainly brought to the organization and imposed on it by some powerful participant groups, it seems entirely plausible that interests also are generated within the organization. Managers who stand to profit from economies realized by increased scale or technical innovation may be expected to coalesce around these "new" interests; and others whose power is closely associated with the condition and survival prospects of the larger enterprise may be expected to champion the interests of the organization as a whole. Thus, we need to allow for the possibility that new interests and new coalitions may emerge over time in response to the opportunities and dangers created by the existence of the organizational structure itself. The dominant coalition model appears able to accommodate these more unified conceptions of goal setting arrangements posited by the rational and natural system analysts.

W. SCOTT, *supra* note 19, at 266.

74. R. CYERT & J. MARCH, *supra* note 19, at 28.

75. *See id.* at 28, 32. Professors Cyert and March maintain that due to limitations on attention focus, corporations attend to goals sequentially. *Id.* at 35. They explain:

> The sequential attention to goals is a simple mechanism. A consequence of the mechanism is that organizations ignore many conditions that outside observers see as direct contradictions. They are contradictions only if we imagine a well-established, joint preference ordering or omniscient bargaining. Neither condition exists in an organization. If we assume that attention to goals is limited, we can explain the absence of any strong pressure to resolve apparent internal inconsistencies.

Id. at 36.

speeds up the assembly line. It may decide to make expensive product improvements at the same time it institutes a policy to cut costs. Moreover, goals are often vague and ambiguous,[76] hiding a considerable amount of disagreement among coalitions.

This state of affairs will not necessarily lead to the demise of the firm. In fact, vague and inconsistent goals may contribute to the survival of the firm because they enlist the support of diverse participants. Also, autonomy among units within the firms, called "loose coupling," permits the organization to adapt successfully to diverse segmented markets.[77] In the efficiency model:

> [T]he assumption is made that the organization is primarily a production system and that when conflicts occur among subunits, they must be resolved. Conflict interferes with goal attainment; and its resolution is associated with greater effectiveness or performance. A quite different view of conflict and conflict resolution processes is associated with the [power model], which presumes that intradepartmental conflict is not primarily a product of error, ambiguity, and ignorance but results from quite fundamental divergencies in group interests; and that the struggles are not concerned simply with means but concerns the goals to be served by the organization.[78]

The power model rejects the notion that the firm secures the support of employees to achieve organizational goals through pecuniary side payments. The paradigm posits that side payments need not be in the form of money, but may be in the form of

76. *Id.* at 28.

77. *E.g.*, H. ALDRICH, ORGANIZATIONS AND ENVIRONMENTS 83-84 (1979); J. PFEFFER & G. SALANCIK, *supra* note 19, at 273; W. SCOTT, *supra* note 19, at 108; *see* Weick, *Educational Organizations as Loosely Coupled Systems*, 21 ADMIN. SCI. Q. 1, 6-7 (1976). Weick argues that loose coupling: (1) may lead to the perpetuation of certain parts of the organization because it "lowers the probability that the organization [as a whole] will have to—or be able to—respond to each little change in the environment"; (2) provides a "sensitive sensing mechanism" that can locally adapt without affecting the whole system; (3) preserves more diversity permitting adaptation to "a considerably wider range of changes in the environment than would be true for a tightly coupled system"; (4) permits breakdown in one part of the system to be "sealed off"; (5) makes more room available for autonomy or self-actualization having favorable motivational consequences and at the same time, limits the consequences of bad decisions; and (6) minimizes coordination costs. *Id.* at 6-8. *Cf.* C. PERROW, *supra* note 19, at 246-47 (arguing that there are advantages in terms of flexibility to non-integrated firms).

78. W. SCOTT, *supra* note 19, at 248.

policy commitments.[79] For example, a sales manager may bargain for an additional salesperson or for a computer system, rather than for additional monetary compensation. This approach is in contrast to the efficiency model wherein "preferences are typically [although not necessarily] thought of as relating to the distribution of consequences of events and actions rather than anything in the nature of those actions and events themselves."[80] In the power model, the interests of participants, on the one hand, and decision making "in roles," on the other, are not so readily separated.

C. *Discussion and Comparison of Models*

The normative foundation for the profit maximization goal is the classical theory of the firm. In that theory, given the existing distribution of wealth and under conditions of perfect information and competition, firms that maximize profits will cause society's resources to be used most efficiently by virtue of Adam Smith's invisible hand. This utilization of resources is efficient not only for shareholders, but also for consumers and employees. Once the underlying conditions of this theory no longer hold, however, efficiency cannot be equated with profit maximization, although corporate law scholars continue to assume such a relationship.[81] The relationship becomes increasingly attenuated as markets become more imperfect. This position is illustrated by examining the behavior of a monopolist: A monopolist maximizes profits by restricting output and raising prices. Resources, including materials and labor, that would be most efficiently utilized in the production of the monopolist's products are diverted to other less valuable uses. The monopolist captures surplus value that would, in a competitive market, go to consumers. In addition, there is a net social loss of value.[82] As the behavior of a

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79. R. CYERT & J. MARCH, *supra* note 19, at 30-32 ("[S]ide payments, far from being the incidental distribution of a fixed, transferable booty, represent the central process of goal specification.").

80. Turk, *Conclusion: Power, Efficiency and Institutions: Some Implications of the Debate for the Scope of Economics,* in POWER, EFFICIENCY AND INSTITUTIONS 189, 201 (1983).

81. *E.g.,* Eisenberg, *Corporate Legitimacy, Conduct, and Governance—Two Models of the Corporation,* 17 CREIGHTON L. REV. 1, 1, 5-6, 17 (1983) (arguing that a shareholder's interest in profits coincides with the social interest in efficiency). This equation of high profits with efficiency permits economic theories to provide normative prescriptions. C. PERROW, *supra* note 19, at 222.

82. R. POSNER, *supra* note 7, at 249-59 (1986).

monopolist thus illustrates, the maximization of profits in an imperfect market is not necessarily consistent with efficiency. The resources of society would be more effectively utilized if the monopolist decreased its profits by lowering its price and increasing the quantity of goods produced. Such losses and inefficiencies occur in all imperfect markets. Profit maximization is not a proxy for pareto optimal efficiency in the real world; neither is cost minimization.[83]

Efficiency is supposed to be a neutral term, referring to the most cost-effective means to an end; however, a particular end must be selected.[84] Although such a choice is not necessary when the invisible hand operates, in the absence of its operation, the choice becomes crucial. For example, as applied to the employee, customer, and shareholder, respectively, efficiency means working for fewer hours or with less effort for a given wage, obtaining a higher quality product for a given price, and minimizing side payments so as to maximize profits. As previously noted, in the classical theory of the firm, these various criteria of efficiency will be effectively handled by classical firms maximizing profits. Nevertheless, in imperfect markets, existing outside an economics textbook, choosing "profit" as the efficiency goal reflects value choices favoring stockholders.[85] The relevant questions in an imperfect market, then, are "efficient for whom?" and "at what cost to others?"

Profit maximization as the corporate goal is also problematic in that the calculation of profit does not account for externalities or third-party effects. Psychic efficiencies or atmospheric effects of different governance structures are also generally not considered.[86] Moreover, profits in the stock market do not necessarily translate into enhancement of the value of underlying assets.[87] The value of profit maximization as a normative goal then is questionable.

According to the efficiency model, the assumption that firms in the aggregate maximize profits need not be proven. This assertion has been extensively criticized because it obviates "a serious concern with the validity of the premises, reasoning, and

83. P. SAMUELSON, *supra* note 33, 586-87 n.4. Professor Samuelson discusses the behavior of a monopsonist in a labor market.

84. H. MINTZBERG, *supra* note 19, at 268-70; H. SIMON, ADMINISTRATIVE BEHAVIOR 179 (1976).

85. H. MINTZBERG, *supra* note 19, at 268-69.

86. Reich & Devine, *supra* note 66, at 32 ("[N]umerous studies have found that differences in working conditions are very poorly or not at all compensated by wage differentials, contrary to competitive wage theory . . . .").

87. *See supra* text accompanying notes 142-43.

facts supporting a conclusion [that] is a hallmark that distinguishes a scientific or scholarly approach from a practical or propagandistic one."[88] As one scholar warns, "[To] get the right answer for the wrong reason may make the theoretical model useless, or worse . . . ."[89]

The natural selection arguments that supposedly buttress this profit-maximization assumption are likewise problematic. First, the argument that profit-seeking behavior determines survival, and that in the long run the most efficient governance structures will survive, is based on competition.[90] The natural selection theories do not, however, specify the amount of competition or time lengths required. To the extent that competition is imperfect, firms are sheltered from competitive pressures. In the United States, for example, failures of firms are largely confined to small businesses, which "constitute a relatively small portion of the total economic activity."[91] Selection appears to occur mostly among small firms operating in highly competitive environments. For the large firm in a less competitive environment, profit-seeking behavior is less important to survival, and its governance structure cannot be presumed to be determined by a process of "natural selection." Governance structures in particular are unlikely to be changed in the absence of a highly competitive environment because they have power implications and are easily "traditionalized." An illustration of this may very well be that management often turns to employee ownership and participatory arrangements at the plant level only when their firms are failing due to competitive pressures.[92]

Second, it should also be noted that the justification of existing governance structures on the basis of natural selection arguments is largely outcome determinative. That is, existing structures that have been around for awhile are presumed to be efficient by definition. These existing structures are then compared to see if cost and incentive arguments can be made to jus-

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88. Winter, *Optimization and Evolution in the Theory of the Firm*, in ADAPTIVE ECONOMIC MODELS 73, 93 (1974); Kornhauser, *A Guide to the Perplexed Claims of Efficiency in the Law*, 8 HOFSTRA L. REV. 591, 621 n.69, 625 n.75 (1980); Nagel, *Assumptions in Economic Theory*, 53 AM. ECON. REV. 211 (1963); Rizzio, *The Mirage of Efficiency*, 8 HOFSTRA L. REV. 641, 645 n.18 (1980). *See generally* Winter, *Economic "Natural Selection" and the Theory of the Firm*, 4 YALE ECON. ESSAYS 225, 242-45 (1964) (stating that natural selection requires various conditions that do not exist in reality).

89. J. PFEFFER, *supra* note 19, at 133.

90. *E.g.*, *id.* at 132; Winter, *supra* note 88, at 98.

91. C. PERROW, *supra* note 19, at 211-12; J. PFEFFER, *supra* note 19, at 186-87.

92. *See generally* J. O'TOOLE, MAKING AMERICA WORK: PRODUCTIVITY AND RESPONSIBILITY (1981).

tify their special features. The problem is that virtually any institution can be justified if enough subjective and objective cost, benefit, and incentive factors are taken into account, because there is no way to weigh any of these variables. Various justifications for existing governance structures are examined in Part IV.

Third, the use of natural selection arguments to justify existing governance structures is suspect because the analysis of institutional structures is made against a static environment. Because the environment is continually changing, there is no way of knowing whether a governance structure is efficient for today or tomorrow. Even if the arguments are valid, they should not be used prescriptively to defend existing institutions as suitable now or in the future. Fourth, it is by "no means certain that an organization that is optimally adjusted to its current environment will be the one which is most able to respond to changes in that environment."[93]

Fifth, the natural selection arguments also tend to be teleological; they assume there is some ideal towards which all things strive.[94] Even if the argument is correct in some sense, the question remains: ideal for whom and at what cost to others?[95] Efficiency, as discussed previously, is not neutral. In commenting on an analogous population ecology model in sociology, Professor Perrow notes:

> [T]he new model of organization-environment relations . . . tends to be a mystifying one, removing much of the power, conflict, disruption, and social class variables from the analysis of social processes. It neglects the fact that our world is made in large part by particular men and women with particular interests. Instead, it searches for ecological laws that transcend the hubbub that sociology should attend to. It will have a promising future, I fear, because it is allied with the prestigious natural sciences, is amenable to the statistical tools we have developed and the emphasis upon large surveys, and is, in a curious way, comforting.[96]

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93. Turk, *supra* note 80, at 193. The premise of the natural selection argument (firms that optimize profit are most likely to survive) has been refuted by a recent simulation study. Witt, *Firms' Market Behavior Under Imperfect Information and Economic Natural Selection,* 7 J. ECON. BEHAV. & ORG. 265 (1986) (rejecting strong and weak form natural selection hypotheses in computer simulation study, assuming imperfect information).

94. *See* C. PERROW, *supra* note 19, at 210.

95. *Id.* at 209-10.

96. *Id.* at 213-14.

Unlike the efficiency model, the power model evidences that reasons other than efficiency can explain the persistence of institutional structures.[97] Moreover, unlike the transaction cost approach where the motive of the corporation is cost minimization, the power model reveals that the principal motivating forces underlying firm behavior are power and autonomy. In addition, the firm is not viewed as being merely "selected" by an environment due to its ability to minimize costs. Rather, a firm molds its environment to suit organizational purposes. The firm is one of the actors constituting the market to whom others must adapt.[98]

It may be argued that the power model's description of the firm applies only to large corporations in less competitive markets. If that is the case, the natural selection argument of the efficiency model tends to explain the behavior of small, numerous organizations in competitive markets, whereas the power model applies to larger organizations in less competitive markets.[99] The power model then would be important for understanding the most important sectors of the American economy.

It may also be argued that the power model explains the behavior of individual firms in the short run, but that the efficiency model, buttressed by the natural selection arguments, provides accurate generalizations about corporations in the long run.[100] However, as previously discussed, the natural selection arguments are unpersuasive.

IV. Firm Behavioral Determinants, the Shareholder-Management Relationship, and the Board of Directors

A. *Efficiency Model*

In addition to the natural selection theory, the efficiency model offers three other theories to explain why existing governance arrangements are efficient. This Section focuses on why shareholders have certain rights, including the right to place representatives on the board of directors to the exclusion of

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97. *See supra* text accompanying notes 65-69.

98. C. Perrow, *supra* note 19, at 212-14; Bauer & Cohen, *The Invisibility of Power in Economics: Beyond Markets and Hierarchies*, in Power, Efficiency and Institutions 81, 94 (1983) (stating that firms "constitute a [system of actors in a market universe] whose functions they simultaneously define").

99. *Cf.* W. Scott, *supra* note 19, at 204-05.

100. Williamson & Ouchi, *The Market and Hierarchies, supra* note 14, at 30. *Cf.* J. Pfeffer, *supra* note 19, at 204; W. Scott, *supra* note 19, at 204-05.

other constituencies. Three theories are explored: the residual rights approach, which places special emphasis on the importance of property rights to incentives and behavior; the related agency cost approach, which focuses upon a number of cost factors and competition in various markets to understand contractual forms; and the transaction cost approach, which emphasizes the importance of asset specific investments made by parties to contractual relationships. This Section will critique the internal logic of these theories. The next section will conclude with the power model's more plausable explanation of existing governance arrangements.

1. Residual rights approach— The residual rights approach attaches great importance to the connection between corporate control and the right to the residual earnings (profits) of the firm. The explanation of this connection is related to the issue of why firms exist in the first place. Before turning to an examination of the residual rights approach, the change in language used by early and more recent residual rights writers must be addressed, because it has a bearing on the conceptual lens provided by the efficiency model. This change in terminology is partially explained by more recent writers' adoption of a different concept of the firm, the "nexus of contracts" concept, as opposed to the prior entrepreneurial concept of the firm.

Early writers described the economic landscape as "islands of conscious power [(firms)] in this ocean of unconscious co-operation [(markets)] like lumps of butter coagulating in a pail of buttermilk."[101] The relevant question was why do these "islands of conscious power" exist? That is, why are organizations necessary or why is an "entrepreneur-co-ordinator, who directs production"[102] needed, when coordination can be accomplished through markets? These questions imply that early writers thought that the distinguishing feature of the firm was the "supersession of the price mechanism"[103] or the replacement of the pricing mechanism with the firm's authority relationships.

More recent writers have rejected this characterization. They maintain that "it is *not* quite correct to say that a 'firm'

101. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 388 (1937) (footnote omitted).

102. *Id.*

103. *Id.* at 389. Professor Coase explained:

> Outside the firm, price movements direct production, which is co-ordinated through a series of exchange transactions on the market. Within a firm, these market transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-co-ordinator, who directs production.

Id. at 388.

supercedes the 'market.' Rather, one type of contract supercedes another type."[104] Queries regarding the necessity of organizations are no longer important, because organizations exist only as nexuses of different kinds of contracts. The concept of firm boundaries, whereby some activities were viewed as being "inside" the firm and ordered by authority and direction and where other activities were viewed as being "outside" the firm and ordered by contract, thus disappears.[105] All relationships with the firm are explained in terms of contracts. There is no generic distinction between relationships with parties "inside the firm," such as shareholders and employees, and relationships with parties "outside the firm," such as suppliers or customers. The firm itself is merely a facilitator for exchanges, much like a wheat market.[106]

This change in perspective tends to downplay the extent to which discretionary authority inheres in certain relationships "within" the firm,[107] and the extent to which firms are islands of "conscious power." This emphasis is typical of the efficiency model. Nevertheless, to stress that all arrangements are contractual also challenges the perception of the market as an "ocean of unconscious buttermilk,"[108] which the efficiency model embraces. While the term "market" often gives the impression of some automatic, unconscious mechanism; in fact, markets are often negotiated environments, particularly for large firms, in which social, cultural, and political factors play a large role.[109]

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104. Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1, 10 (1983) (emphasis in original). Professors Alchian and Demsetz explain:

> It is common to see the firm characterized by the power to settle issues by fiat, by authority, or by disciplinary action superior to that available in the conventional market. This is a delusion. The firm does not own all its inputs. It has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people.

Alchian & Demsetz, *supra* note 14, at 777.

105. Jensen & Meckling, *supra* note 14, at 311. The power perspective defines a firm's boundaries as follows:

> The organization is the total set of interstructured activities in which it is engaged at any one time and over which it has discretion to initiate, maintain, or end behaviors. . . . The boundary is where the discretion of the organization to control an activity is less than the discretion of another organization or individual to control that activity.

J. PFEFFER & G. SALANCIK, *supra* note 19, at 32.

106. Alchian & Demsetz, *supra* note 14, at 777.

107. This view is not shared by the transaction cost theorists, however. *See infra* text accompanying notes 173-227.

108. Coase, *supra* note 101, at 388.

109. *See, e.g.*, Granovetter, *Economic Action and Social Structure: The Problem of Embeddedness*, 91 AM. J SOC. 481 (1985); MacCauley, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).

Accordingly, the change in terminology intentionally downplays the extent to which "conscious power" is exercised by firms. On the other hand, it also has the unintended consequence of confirming the extent to which markets are not characterized by "unconscious cooperation." It therefore suggests some characteristics of the power model.

The problematic residual rights approach is reflected in two theories that place importance on the connection between firm control and the right to residual earnings. These theories are referred to herein as the "modes of payment" and the "incentive-residual rights" theories. The first theory is an early theory that mainly deals with control of the classical capitalist firm by the entrepreneur (owner-manager). The second more modern theory extends its explanation to the public corporation with diffuse ownership.

a. Modes of payment theory— According to the "modes of payment" theory, organization of the firm is explained by the specialization of the entrepreneurial function which is required under conditions of uncertainty.[110] The specialization of this function requires a differentiation of rewards or "modes of payment."[111] Variable profits (or the residual) go to the entrepreneur who controls production and fixed contractual payments to

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110. F. KNIGHT, RISK, UNCERTAINTY AND PROFIT 267-70 (1921). According to Professor Knight, in the absence of uncertainty, there would be no need "for anything of the nature of the responsible management or control of productive activity." *Id.* at 267. While a "coordinator" of the activities of individuals may be necessary, "such functionaries would be laborers merely, performing a purely routine function, without responsibility of any sort, on a level with men engaged in mechanical operations." *Id.* at 268. According to Professor Knight, with uncertainty "the primary problem or function is deciding what to do and how to do it." *Id.* at 268. The actual doing of things becomes secondary in importance. A "new economic functionary," *id.* at 268, the entrepreneur, is therefore created, specializing in decision making under uncertainty. Because "men differ in their powers of effective control over other men as well as in intellectual capacity to decide what should be done," *id.* at 269, the centralization of this management function in experts through the organization of the firm provides least cost results.

Professor Coase disagreed with Knight's belief that the organization of the firm was due to the specialization of the entrepreneurial function. Coase states:

> [T]he fact that certain people have better judgment or better knowledge does not mean that they can only get an income from it by themselves actively taking part in production. They can sell advice or knowledge. Every business buys the services of a host of advisors. We can imagine a system where all advice or knowledge was bought as required. Again, it is possible to get a reward from better knowledge or judgment not by actively taking part in production but by making contracts with people who are producing.

Coase, *supra* note 101, at 400-01; *see also* Cheung, *supra* note 102, at 5-6 ("[I]f every activity is measured and priced, then benefits arising from specialization and coordination can be realized" by market exchanges.).

111. F. KNIGHT, *supra* note 110, at 271.

factors of production. This argument is primarily based on practical considerations:

> With human nature as we know it it would be impracticable or very unusual for one man to guarantee to another a definite result of the latter's actions without being given power to direct his work. And on the other hand the second party would not place himself under the direction of the first without such a guaranty.[112]

Thus, fixed payments and the relinquishment of control, or, alternatively, profit sharing and control, go hand in hand.

This theory, however, cannot withstand analysis. The case of independent contracting, for example, is contrary to the coupling of profit sharing and control.[113] Independent contractors maintain control over work performed, but are often promised fixed payments. Assurances that the work will be performed properly can be given without the purchaser controlling the work. In addition, employees who relinquish control over their labor often enter into profit sharing agreements.[114] Although the positive incentive effect of profit sharing may be diminished if employees have little control over decisions affecting profits,[115] profit-sharing is nevertheless attractive to some employees, depending on their attitudes towards risk.[116] It has been suggested that shareholders, who share in profits, and debtholders, who receive fixed payments, differ not in their interest in controlling the company, but only in their attitude towards risk and their

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112. *Id.* at 270. Professor Knight also associates with the new economic functionary (the entrepreneur) confidence in his judgment and powers that permits him to assume the risk and guarantee the "doubtful and timid" a specific return. *Id.* at 270. In addition, at one point Professor Knight stresses the importance of bonding. Although he concedes the possibility of an entrepreneur investing no money in the business and offering as security his own earning power, he claims "the potential earning power of the entrepreneur himself . . . might not be marketable on account of a moral hazard without being underwritten by a property-owning connection." *Id.* at 274 n.1, 289 n.1.

113. Coase, *supra* note 101, at 401.

114 Coase, *supra* note 101, at 392 ("[O]ne entrepreneur may sell his services to another for a certain sum of money, while the payment to his employees may be mainly or wholly a share in profits.").

115. *E.g.*, R. KATZELL & D. YANKELOVICH, WORK, PRODUCTIVITY AND JOB SATISFACTION: AN EVALUATION OF POLICY-RELATED RESEARCH 324 (1975). "Generally, [cognitive theories of worker motivation] hold that an important influence on worker motivation is the extent to which the employee sees a connection between his increased output and the rewards he receives." *Id.* For further information on motivation, see *infra* text accompanying notes 123-31.

116. Klein, *supra* note 14, at 1534 (categorizing employee profit sharing as a high-risk claim). According to Professor Knight, employees, unlike the entrepreneur, are risk averse. *See supra* note 112.

degree of optimism concerning the future of the company.[117] Practical considerations as to appropriate modes of payment, therefore, do not necessarily account for control by the entrepreneur of the classical capitalist firm.[118]

b. Incentive-residual rights approach— The second residual rights theory, the incentive-residual rights approach, argues that control of the corporation by the entrepreneur is the most efficient arrangement because the ownership of residual rights provides an incentive to maximize the performance of the firm. Coordination of activities within the firm is explained by the difficulty of metering the outputs of various factors of production when team production is involved (for example, the joint lifting of cargo by two men).[119] A central coordinator (or entrepreneur) can efficiently estimate the marginal productivity of each input by observing the behavior of inputs.[120] In addition, through monitoring, the central coordinator can decrease shirking, which is encouraged by the difficulty of metering where team production is involved.[121] Thus, inputs are more efficiently utilized under the direction of a central monitor than through market exchanges.

This analysis does not explain, however, why the entrepreneur must also be entitled to all the profits. The connection between control and the right to the residual is explained by the fact that the central monitor will have an added incentive not to shirk and to utilize the resources of the team most efficiently if he is also entitled to the profits.[122] In this way, the incentive-residual

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117. Alchian & Demsetz, *supra* note 14, at 789 n.14.

118. Professor Knight does discuss the modern corporation with many shareholders. He maintains that the neglected feature of the "*responsible direction* of economic life . . . [is] the inseparability of these two elements, [financial] *responsibility* and *control.*" F. KNIGHT, *supra* note 110, at 271 (emphasis in original). That is, "[a]ny degree of effective exercise of judgment, or making decisions, is in a free society coupled with a corresponding degree of uncertainty-bearing, of taking responsibility for those decisions." *Id.* at 271. Despite diffuse ownership in the modern corporation, he concludes that the separation of ownership and control is "illusory," when "control is accurately defined and located." At this point, a fair amount of confusion enters Knight's analysis. He says that control principally means "the selection of men to make decisions." *Id.* at 297. At another point, he elaborates on what he means by this which demonstrates that he is primarily referring to the functions of the entrepreneur in the classical firm: "The responsible decision relates to men rather than things, the ultimate manager is he who plans the organization, lays out functions, selects men for functions and appraises their value to the organization as a whole, in competition with all other bidders in the market." *Id.* at 308.

119. Alchian & Demsetz, *supra* note 14, at 779-80.

120. *Id.* at 780.

121. *Id.*

122. Alchian & Demsetz, *supra* note 14, at 782.

rights theory justifies control by the entrepreneur of the classical capitalist firm.

Proponents of this theory reject profit sharing among members of large teams, because each team member would receive only a small percentage of the profits. Under this arrangement, it is said that more shirking can be expected by employees, because "only a smaller percentage of the losses occasioned by the shirker will be borne by him."[123] The incentive-residual rights theory does not recognize that the smaller percentage loss suffered by the employee may nevertheless be significant to the employee if he is aware of the personal loss that his shirking will produce.[124] That is, the employee does not have to be entitled to the full "output" from his efforts to be motivated to obtain a fraction. In fact, one could argue that he might even work harder in that situation. What is significant to his motivation is the percentage of his wealth tied up in the profits of the company and the degree to which there is a connection between his efforts and the percentage of the company's earnings he is entitled to receive.[125]

The corollary to the statement that the employee bears only a small percentage of the costs of his shirking is that he is entitled to a small fraction of the "output" his efforts produce. This is true only in a very narrow sense. Unless the employee is being exploited, other factors contribute to his output. Thus, the employee's motivation would not be adversely affected by the notion of sharing implied by this reasoning.[126]

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123. *Id.* at 786; *see also infra* note 126 (regarding the significance of shirking).

124. *Cf.* Anderson, *supra* note 40, at 784-86 (discussing incentive compensation plans and stock ownership for management).

125. Indeed, the measurement issue is the problem. This measurement problem also exists for the central monitor. His efforts will only be reflected imperfectly in the firm's profits. This problem is reflected in the probabilities used in calculating the effort/reward ratio in expectancy theory. *See infra* text accompanying note 129.

126. See *infra* note 133 and text accompanying notes 146-49 for discussion of equity theory. Professor Perrow would not give central importance to shirking in understanding organizations. He explains that employees' utilities are not likely to be achieved by shirking, but rather by seeking "safe work, interesting work, opportunity to use and develop skills, some autonomy, influence in decisions that affect not only working conditions but the efficiency of the organization." C. PERROW, *supra* note 19, at 230. In addition, Professor Perrow maintains that this incentive-residual rights approach ignores the incentive of the control monitor to act opportunistically with respect to the employees of the firm. He points out that "[e]xploitation of employees would appear to be a problem at least as great as, and probably far greater than, shirking by employees, given the self-interest assumed to drive the model and the obviously superior resources of the monitor, entrepreneur, CEO, or capitalist." *Id.* at 227. This analysis draws attention to the asymmetrical nature of the relationship that is based upon authority rather than contract. *Id.* at 226-28, 230.

Proponents of the incentive-residual rights theory also make the unsupported empirical assumption for large teams that:

> the cost of team production is increased if the residual claim is not held entirely by the central monitor. . . . [I]f profit-sharing had to be relied upon for *all* team members, losses from the resulting increase in central monitor shirking could exceed the output gains from the increased incentives of other team members not to shirk.[127]

Factors relevant to motivation, however, are not taken into account in making this assumption.

First, there is no necessary linear relationship between increasing percentage rights to profits and increasing profit-seeking motivation. It is more likely that there is a decreasing return to scale as the absolute monetary rewards to the central monitor increase. At some point, it will be more efficient for the firm to share profits with employees than to have all profits go to the central monitor.[128]

Second, expectancy theory provides that motivation depends on the value of the reward multiplied by the expected effort/reward ratio.[129] The ratio measures the expected amount of effort required to receive a given reward. Rewards, however, are not only in the form of money, but include such things as status or prestige, the nature of the work itself, increased responsibility, and opportunities for personal growth.[130] Opportunities to pursue these other values are more available to top managers than to lower-level employees, because of the greater degree of discretion possessed by top managers. The pursuit of these val-

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127. Alchian & Demsetz, *supra* note 14, at 786.

128. This concept is similar to the satiation concept invoked by needs theorists.

129. Unlike reinforcement and drive theories, expectancy theory recognizes that individual thoughts and intentions influence behavior. The description in the text reflects the Porter-Lawler model of expectancy theory. *See* L. PORTER & E. LAWLER, MANAGERIAL ATTITUDES AND PERFORMANCE 10-14 (1968). Actually the expected effort/reward ratio is composed of two components: (1) the perceived contingency relationship between effort and performance (sometimes referred to as "expectancy"), and (2) the perceived contingency relationship between performance and reward (sometimes referred to as "instrumentality"). *See id.* at 179-80; Campbell & Pritchard, *supra* note 71, at 78. The theory is somewhat more complex, however, embracing three feedback loops: (1) actual reward practices influence subsequent calculations of the effort/reward ratio; (2) the experience of satisfaction with the outcome will affect its future value; and (3) the effort/reward contingency will be influenced by experiences of success or failure and their impact on the individual's general self-esteem. L. PORTER & E. LAWLER, *supra*, at 129; Campbell & Pritchard, *supra* note 71, at 78-79; *see also* E. Lawler, Motivation in Work Organizations (1973).

130. D. HELLRIEGEL, J. SLOCUM & R. WOODMAN, *supra* note 63, at 376-77.

ues, such as the nature of the work itself or increased responsibility, may or may not be related to profit. The chief executive, for instance, may be interested in building new modern structures or in personally overseeing certain projects, although from the firm's perspective, this is not profit-maximizing behavior. Moreover, numerous opportunities for self-actualization are provided by our society to persons in senior positions.[131] It is likely, therefore, that factors other than money have a greater impact on managerial motivation than on that of lower-level employees. Some profit sharing with employees may have a greater effect on profit-maximizing behavior within the firm than if all profits were to go to the top manager.

Third, greater incentives or rewards in terms of profits to managers can have an impact on the incentives of others in the organization. The equity theory of motivation—unlike the expectancy theory, which has an individual orientation[132]—indicates that motivational decisions are made by comparing the relationship of one's input/output ratio to the input/output ratio of others.[133] Increased management monitoring of

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131. In addition, researchers have found that top managers are better able to satisfy self-actualization needs, because of the nature of their jobs, which are more challenging than those of lower-level employees. *Id.* at 364.

132. *Id.* at 383.

133. Adams, *Toward An Understanding of Inequity*, 67 J. ABNORMAL & SOC. PSYCHOLOGY 422, 424 (1963) [hereinafter Adams, *Toward an Understanding*]. *See generally* Adams, *Inequity in Social Exchange*, 2 ADVANCES EXPERIMENTAL SOC. PSYCHOLOGY 267 (1965); Campbell & Pritchard, *supra* note 71; Vecchio, *An Individual-Differences Interpretation of the Conflicting Predictions Generated by Equity Theory and Expectancy Theory*, 66 J. APPLIED PSYCHOLOGY 470 (1981). Equity theory is based on cognitive dissonance and social comparison processes. Under this theory, differences between the input/output ratios of a person and a comparison "other" result in tension that the person is motivated to reduce. The amount of tension is proportional to the amount of inequity, or the magnitude of the differences between the input/output ratios. Tension reduction is accomplished by restoring equity, which may be accomplished by (a) altering the inputs or outputs, (b) distorting reality and convincing oneself that the situation is fair, or (c) leaving the firm or withdrawing.

> For example, imagine a secretary who feels her boss underpays her. She could reestablish actual equity in various ways: She could neglect her work (thus lowering her own inputs), demand a raise (thus raising her own outcomes), make mistakes so that the boss will have to work harder undoing what she has done (thus raising the boss' inputs), or sabotaging company equipment (thus blowering her boss' outcomes).

Hatfield & Sprecher, *Equity Theory and Behavior in Organizations* in 3 RES. SOCIOLOGY ORGANIZATIONS 95, 98 (1984). Or, alternatively, she could conclude that she really does not deserve to be paid more or that her boss really works much harder than she does. Of course, the boss may or may not serve as her "other" or reference group. *See* Ronen, *Equity Perception in Multiple Comparisons: A Field Study*, 39 HUM. REL. 333 (1986) (suggesting that reference groups outside the firm are more important than inside reference groups in explaining job attitudes and behavioral propensities of employees in manufacturing firms). In addition, inequity may be less likely to occur in an impersonal ex-

employees for the purpose of causing them to increase their efforts can cause the employees to believe that others are profiting at their expense. Moreover, profits often change in ways unrelated to managerial input, which can accentuate the disparity in the output/input ratios of managers and employees, and create further adverse motivational consequences within the firm.

There is also substantial evidence that employee ownership,[134] profit sharing, and gain sharing[135] can have positive effects on the productive ability of the firm. Because the motivational relationship between an employee's individual effort and the resulting profits of the firm is attenuated, I propose that the increase in productivity associated with such arrangements can be attributed to the social comparison rationale of the equity theory (rather than to expectancy theory).[136] For all of the above rea-

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change relationship. Campbell & Pritchard, *supra* note 71, at 110. Professor Adams explains:

> Evidence suggests that equity is not merely a matter of getting "a fair day's pay for a fair day's work," nor is equity simply a matter of being underpaid. The fairness of an exchange between employee and employer is not usually perceived by the former purely and simply as an economic matter. There is an element of relative justice involved that supervenes economic and underlies perceptions of equity or inequity.

Adams, *Towards an Understanding*, *supra*, at 422.

134. *See generally* I. WAGNER, REPORT TO THE NEW YORK STOCK EXCHANGE: PERFORMANCE OF PUBLICLY-TRADED EMPLOYEE OWNERSHIP COMPANIES 3-4 (1984); Conte & Tannenbaum, *Employee-Owned Companies: Is the Difference Measurable?*, 101 MONTHLY LABOR REV. 97 (1978); Jones & Svejnar, *Participation, Profit Sharing, Worker Ownership and Efficiency in Italian Producer Cooperatives*, 52 ECONOMICA 449 (1985).

135. More case study documentation of gain-sharing plans is needed. Bullock & Lawler, *Gainsharing: A Few Questions, and Fewer Answers*, 23 HUMAN RESOURCE MGMT. 23, 38 (1984). Bullock and Lawler found only 83 such studies in the literature. They summarize the literature as follows:

> About three quarters of the gain-sharing plans reported some improvements in productivity, quality, cost reduction, or customer service. About two-thirds reported improvements in individual attitudes, morale, or quality of worklife. Over three-quarters reported more ideas, more suggestions, more innovations. Over one-half reported improvements in labor-management relations, working with the union, or better communication and cooperation between supervisor and worker. All but three cases reported at least some bonuses and pay increases based on performance improvements.

Id. at 31. There are a number of different kinds of gain-sharing plans, including the Scanlon, Improshare, and Ruckers Plans. Implementation of these plans generally involves some participation by employees and a formula for determining bonuses. *Id.* at 24. *See generally* R. KATZELL & D. YANKELOVICH, *supra* note 115, at 355; NEW YORK STOCK EXCHANGE, INC., PEOPLE AND PRODUCTIVITY: A CHALLENGE TO CORPORATE AMERICA 32-39 (1982); Fein, *Gain-sharing Is Antidote to Problems Between Workers and Managers*, INDUS. ENGINEERING 50, 60-62 (1983) (describing study of 72 companies that established Improshare Plans showed 22.2% increase in productivity in first year).

136. A variety of explanations have been offered for this increased productivity other than the one offered in this article. Some argue that the increased productivity primarily results from economic motivation. *E.g.*, Geare, *Productivity From Scanlon-type Plans*, 1

sons, the efficient organization of the classical capitalist firm cannot be explained by reference to the right to the residual belonging to the entrepreneur.

Of course, in the modern corporation, residual rights are not held entirely by the central monitor. Stock ownership is shared among shareholders, managers, and employees. Nevertheless, the incentive-residual rights theory is not abandoned by residual rights theorists in this context to explain the efficient organization of the firm. Residual rights, according to this theory, remain the central motivating force ensuring the efficiency of the firm. Although shareholders have only limited voting rights, it is said that shareholders control management by "exiting" the firm, thereby causing the price of the company's stock to fall. The decrease in stock price affects management's ability to acquire financing for the firm and sets in motion the "market for corporate control" in which large residual owners displace presumably inefficient management.[137] Moreover, capital market pressures cause firms to adopt compensation arrangements for management that align the interests of shareholders and management.[138] Accordingly, the theory maintains that residual owners are in control of the modern corporation, although indirectly through the operation of markets.

There are several problems with this explanation of supposedly efficient shareholder control of corporations. First, efficiency theorists argue against the expansion of existing shareholder voting rights on the basis of the individual shareholder's small "percentage" interest in the firm.[139] According to this argument, individual shareholders do not have the economic in-

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ACAD. MGMT. REV. 99 (1976). Others argue that it is due to the increased involvement and participation of employees in the workplace. *E.g.*, Rosenberg & Rosenstein, *Participation and Productivity: An Empirical Study*, 33 INDUS. & LABOR REL. REV. 355 (1980). A recent argument stated that gain-sharing changes the culture of the organization:

> Gain-sharing plans appear to transform individuals, working on their own tasks and largely unaware of how their jobs interface with the whole of the organization, into groups of employees which suddenly have a much broader understanding of and commitment to the total enterprise and its success. This can encourage employees to work smarter and perhaps harder because they feel they are part of an ongoing team which needs their energy, ideas and allegiance if it is to win.

Bullock & Lawler, *supra* note 135, at 37.

137. *E.g.*, Alchian & Demsetz, *supra* note 14, at 788; Manne, *supra* note 13, at 265-66.

138. Jensen & Zimmerman, *Management Compensation and the Managerial Labor Market*, 7 J. ACCT. & ECON. 3 (1985).

139. Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402, 424-25 (1983); *see supra* text accompanying notes 15-18 and *infra* note 259. *But see* M. EISENBERG, *supra* note 7, at 64-65 ("Most of the stock in any given publicly held corporation is in the hands of a relatively small number of sophisticated holders . . . .").

centive to monitor the corporation effectively. These same small shareholders nevertheless are perceived as efficiently controlling the firm by selling their shares and thus causing the stock price to fall. Exiting is considered a positive force in corporate governance because it activates the market for corporate control. Yet monitoring by exiting is done by shareholders whose individual incentive to monitor effectively is rejected by the efficiency theorist.[140] The efficiency theorist fails to explain how this individual disincentive to monitor effectively results in effective monitoring when the behavior of shareholders is viewed in the aggregate. Second, operation of the "market for corporate control" may not result in a more efficient utilization of resources.[141] Takeovers

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140. If reliance is placed on market professionals and institutional investors to monitor effectively, *e.g.*, Jensen & Ruback, *The Market for Corporate Control*, 11 J. FIN. ECON. 5 (1983) then the incentives of these individuals need to be examined, rather than those of the residual rights owners. For example, institutional investors may be more interested in short-term rather than long-term profitability of companies. Conard, *The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law*, 82 MICH. L. REV. 1459, 1476 (1984); Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1,7 (1987); Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 280 n.127, 292-93, 300, 301 n.209, 302 n.214 (1983). Moreover, with the teachings of the efficient market hypothesis, the incentives of institutional traders should be examined very closely, particularly in light of the enormous amount of trading occurring on the stock exchanges. *Impact of Corporate Takeovers: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 99th Cong., 1st Sess. 115 (1985) [hereinafter *Impact of Corporate Takeovers*] (statement of Professor Lowenstein); Lowenstein, *supra*, at 300. Note that the Securities and Exchange Commission relies upon the incentive of shareholders. It appears to agree with the statement that, "Since the shareholders are betting their own money, they can be relied on to protect not only their own interests but society's as well . . . ." *Impact of Corporate Takeovers*, *supra*, at 292.

141. The issues as to (1) whether takeovers are beneficial to the economy, and (2) whether they are related to managerial performance or excessive managerial compensation have not been resolved. First, the purported beneficial effects of tender offers and mergers are demonstrated by reference to stock price changes rather than actual improvements in operating performance. *See generally* Jensen & Ruback, *supra* note 140. Whether a beneficial effect is found depends upon the dates chosen for measuring stock price changes. Studies on mergers, for example, show positive abnormal returns from the announcement date through the outcome date. Significant negative abnormal returns have been found in the year following the mergers. As Professor Jensen and Ruback explain, "Explanation of these post-event negative abnormal returns is currently an unsettled issue." *Id.* at 22. They are also "unsettling," according to these authors, because "they are inconsistent with market efficiency and suggest that changes in stock price during takeovers overestimate the future efficiency gains from mergers." *Id.* at 20. In addition, studies of actual operating results raise considerable doubt as to the inferences drawn from the stock market studies. Johnson, *supra* note 18, at 205. Second, the increasing debt/equity ratio of businesses taken over also has to be taken into account in assessing the beneficial effects of takeovers. *Regulating Hostile Corporate Takeovers: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong. 1st Sess. 227-28 (1987). Third, takeovers may not be due to poor managerial performance or excessive managerial compensation. *See* Coffee, *Regulating the Market for*

may very well result from persons merely arbitraging two markets: the stock market and the market for underlying corporate assets.[142] The argument concerning the beneficial effects of the operation of the market for corporate control rests upon the assumption that the stock market is efficient in valuing underlying assets. This assumption is being increasingly challenged.[143]

Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance, 84 COLUM. L. REV. 1145, 1206-07 (1984); Lowenstein, *supra* note 140, at 292-93, 294 n.186, 295-96 (stating that a growing number of leveraged buyouts is keeping management in control), 306. *But see*, Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1165 (1981) (stating that the stock price of target companies prior to takeover demonstrates an underperformance of market). However, the SEC's Advisory Committee on Tender Offers concluded that "while in certain cases takeovers have served as a discipline on inefficient management, in other cases there is little to suggest that inefficiency of target company management is a factor." SEC ADVISORY COMM. ON TENDER OFFERS REPORT ON RECOMMENDATIONS 8-9 (1983). Moreover, evidence that stock prices of rivals in the industry also increase at the time of the tender offer indicates gains are more general, yet "removal of inefficient target management is unlikely to be an industry-wide phenomenon." Jensen & Ruback, *supra* note 140, at 25. Professor Lowenstein found that all industrial companies that were targets of hostile takeovers in 1981 had a return on equity of 16%, hardly consistent with inefficient management. *Impact of Corporate Takeovers*, *supra* note 140 (statement of Professor Lowenstein), at 117. Moreover, he found that the premiums were largely attributable to tax gains. *Id.* at 118. See Lowenstein, *supra* note 140, at 289 n.165 for summary of results of 1981 takeover bid study. *See also* C. PERROW, *supra* note 19, at 251 n.35. *But see* Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 895-97 (1988). "[T]ax effects seldom appear to have been primary motives for acquisitions." *Id.* at 896.

142. Professor Lowenstein suggests that two markets are involved, the day-to-day trading market and the market for entire companies:

> When one looks at oil companies as a whole, one finds prices that would be in the range of $6 to $8 a barrel. . . . [A]t the moment if you buy a share of Exxon you're buying oil at $3 a barrel. There are 17 barrels of oil per share of Exxon and Exxon sells for less than $50 a share. Is the market pricing shares in Exxon efficiently? Perhaps in the day-to-day trading market. Is that relevant to the whole company price of Exxon? I submit to you that it's not. . . . The same would be true of property and casualty insurance companies which almost invariably sell for ratios to book value of about 175 percent and yet one can buy property and casualty insurance companies in the day-to-day market at figures not much above and sometimes below book value rather than at the large premium. . . . In effect, what Mr. Pickens, Mr. Steinberg, and Mr. Icahn and the like are doing is simply arbitraging two markets. We have the day-to-day trading market with its set of pricing criteria, too often focused on a high turnover performance game played by institutional investors, and we have a quite different market for corporate control and whole companies.

Impact of Corporate Takeovers, *supra* note 140 (statement of Professor Lowenstein), at 109-10; *see also* Lowenstein, *supra* note 140, at 274 (concluding that "whatever the market's long-run tendencies toward efficiency may be, they are only that—tendencies").

143. A number of studies indicate that the stock market is not efficient from a "fundamental-valuation," as opposed to "information-arbitrage," point of view. *See generally*, Lowenstein, *supra* note 140, at 283-87; Wang, *Some Arguments That the Stock Market is Not Efficient*, 19 U.C. DAVIS L. REV. 341, 344 (1986) for summaries of various studies. Keynes long ago argued that stock markets do not reflect intrinsic value at all, but reflect the outcome of individuals trying to predict how the crowd will act in the

Third, even if the market for corporate control operates to displace inefficient management, the substantial premiums offered to shareholders in takeovers indicate substantial inefficiency in the governance structure of the firm.[144]

Lastly, it is inconsistent to argue that management will be appropriately motivated by compensation linked to stock price performance while maintaining that employees will not be similarly motivated with profit-sharing arrangements. Even if this inconsistency is put aside (as will also be explored in the next Section), studies of the relationship between stock performance and executive compensation do not necessarily bear out the managerial incentive argument. These studies can be interpreted in different ways. For example, studies showing that an eleven-percent rise in stock market prices followed an announcement of a short-term incentive-compensation plan do not necessarily demonstrate that the market expects this plan to motivate managers to achieve higher operating results (the incentive hypothesis). It may instead mean that the market is being informed by executives that they believe that their company's operating results will be higher and, therefore, are arranging to have their compensation dependent on those results (information hypothesis).[145]

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future (thus investors "play the market"). J. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 153-57 (1936). His analogy of the stock market to a beauty contest has been found accurate by recent writers, one of whom has argued that social dynamics (fashions or fads) heavily influence stock prices. Ackley, *Commodities and Capital: Prices and Quantities*, 73 AM. ECON. REV. 1, 12-14 (1983). *See generally*, Kraakman, *supra* note 141, at 898-901 (discussing market hypothesis). This could explain why prices of other firms in the industry go up when one firm in the industry is the subject of a tender offer.

144. If takeovers are indeed due to managerial inefficiencies, *see supra* note 141, and stock prices are a reflection of that inefficiency, the large premiums (30% average abnormal returns) reflect that a substantial degree of inefficiency is required before the market for corporate control will operate. Brudney, *supra* note 50, at 1425-26; *see also* Lowenstein, *Hostile Takeovers: A Remedy of First Resort or Last Resort*, 15TH ANN. SEC. REG. INST. 9 (1988) ("average premium over market for large number of transactions in the late 1970's and early 1980's was 80 percent"). The costs of such tender offers cannot be overlooked. These costs include share acquisition costs, legal and other professional costs, and costs of solicitation and advertisements. One article estimates that the costs of such takeovers range from $6 million to $17 million. Metz, *Outside Professionals Play an Increasing Role in Corporate Takeovers*, Wall St. J., Dec. 2, 1980, at 1, col. 6; *see* Lowenstein, *supra* note 140, at 31 ("At an average of four percent of transaction values, the fees [for takeovers] have been aggregating about $6-7 billion a year.")

145. Correlational studies do not demonstrate the direction of causality. *See* Jensen & Zimmerman, *supra* note 138, at 6 (arguing that the market price reaction could also be due to the tax effect of such compensation plans); Raviv, *Management Compensation and the Managerial Labor Market, - An Overview*, 7 J. ACCT. & ECON. 239 (1985). Although the correlations between executive compensation and current year stock prices are statistically significant, they are "low" and much of "the variance in executive com-

In summary, the residual rights approach does not demonstrate that control rights in the modern corporation are organized to ensure the efficient utilization of resources. The modes of payment theory does not describe reality. The incentive-residual rights theory is also not particularly persuasive in arguing for the superior efficiency of existing control structures.

The equity theory, discussed above,[146] also suggests that the residual rights approach, with its emphasis on individual maximization assumptions, does not provide an adequate paradigm for the efficient control of the modern corporation. The equity theory suggests that in exchange relationships, particularly the long-term or more intimate ones,[147] equity is important to motivation and should be considered. For example, one study demonstrates that, contrary to the utility maximization assumption (utilized in expectancy theory), persons will withdraw from an inequitable situation to one less profitable, but more equitable.[148]

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pensation remains unexplained." Jensen & Zimmerman, *supra* note 138, at 4. For excellent criticism of the significance of these studies, see Brudney, *supra* note 50, at 1422-43. *See also infra* text accompanying notes 268-71 on shareholders' attempts to determine executive compensation.

146. *See supra* text accompanying note 133.

147. Equity theory has been applied to various relationships. *See* Berkowitz & Walster, *Equity Theory: Toward a General Theory of Social Interaction*, 9 ADVANCES EXPERIMENTAL SOC. PSYCHOLOGY 1 (1976). It has not yet been applied to the shareholder-management relationship.

148. Schmitt & Marwell, *Withdrawal and Reward Reallocation as Responses to Inequity*, 8 J. EXPERIMENTAL SOC. PSYCHOLOGY 207 (1972). In this study, pairs of subjects had the choice between working individually or cooperatively. Each subject would make more if they cooperated than if they worked individually. When one subject received either two, three, or five times as much as the other subject, the amount of cooperation decreased, with the lower-paid subject opting to forego the rewards of cooperation to avoid the inequitable condition. Some withdrawal occurred in 40% of the pairs under large inequity, in 25% of the pairs under moderate inequity, and in 15% under small inequity. When persons were permitted to make transfer payments though, cooperation increased and partial or full equity was restored. *Accord* Hoffman & Spitzer, *Entitlements, Rights, and Fairness: An Experimental Examination of Subjects' Concept of Distributive Justice*, 14 J. LEGAL STUD. 259 (1985). There is some evidence that the equity effect is short-lived. *E.g.*, Lawler, Koplin, Young & Fadem, *Inequity Reduction over Time in an Induced Overpayment Situation*, 3 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 253 (1968). In addition, some overpayment studies, which have induced persons to feel overpriced by manipulating the subjects' perceived qualifications, have been criticized because subjects may have been responding not to inequity, but to threatened self-esteem and/or job security. *E.g.*, Wiener, *The Effects of "Task-and "Ego-Oriented" Performance on Two Kinds of Over compensation Inequity*, 5 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 191 (1970). *See generally* Campbell & Pritchard, *supra* note 71, at 106-07. The Schmitt and Marwell study, however, noted that "the data for moderate and large nonrectifiable inequity conditions indicate that there is more interruption [noncooperation] the longer the time spent under the [inequitable] condition, and the length of each interruption tends to become longer." Schmitt & Marwell, *supra*, at 219. A re-

The equity theory is at odds with the law and economics literature. While equity may be worked into the utility maximization framework of the efficiency model by observing that inequity can decrease the value or utility of a reward,[149] it requires the consideration of social, cultural,[150] and distributional consequences. An analysis of "efficient" governance structures would take into account not only metering and monitoring concerns, but social, cultural, and distributional consequences as well.

2. *An addendum on incentives: the stakeholder's argument*— Rather than rationalizing existing governance structures that grant substantial discretion to managers by relying on the incentive of residual rights owners to monitor managerial performance, the recent tendency among law and economics writers is to reach that same result by arguing that managers have a "legitimate interest in control,"[151] because of their "stake" in the enterprise.

> Managers' compensation and reputation may depend on the success of the business; as a result, they must be concerned with control to protect and enhance that bargained-for element of their compensation. In fact, man-

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cent study by Vecchio did not threaten self-esteem. The equity effect of the overpayment situation was confirmed. Vecchio suggested in that study that the permanence of the equity effect may be a function of individual differences in moral maturity among subjects. Vecchio, *supra* note 133, at 479. Note that the self-interest assumption of law and economics is virtually identical to Kohlberg's lowest state of moral development. Harrison, *Egoism, Altruism and Market Illusion: The Limits of Law and Economics*, 33 UCLA L. REV. 1309, 1322-24, 1337-38 (1986). Persons may cooperate in a situation where the most rational course of action would be otherwise, perhaps due to a sense of identity with a group or community values. Higgs, *Identity and Cooperation: A Comment on Sen's Alternative Program*, 3 J.L., ECON. & ORGANIZATION 140 (1987); Sen, *Goals, Commitment, and Identity*, 1 J.L., ECON. & ORGANIZATION 341 (1985).

149. Some theorists view the equity theory as a corollary to the expectancy theory in much this same way, where inequity can effect the "valence of rewards." Lawler, *Equity Theory as a Predictor of Productivity and Work Quality*, PSYCHOLOGY BULL. 596, 609 (1968). Equity theory and expectancy theory come from two different traditions, however. Expectancy theory posits that people seek to maximize their positive outcomes. Human nature is hedonistic or selfish. In contrast, equity theory holds that individuals seek to balance inputs and outputs. The behavior described is of individuals seeking equity or justice in a social setting. *See* Vecchio, *supra* note 133. The cognitive and behavioral effects of inequity will be felt by an overpaid person only if that person feels he is treating someone else unfairly. In the large impersonal organization, overpayment may not have the equity effect. Campbell & Pritchard, *supra* note 133, at 108. More research needs to be done before any firm conclusions can be drawn about the operation of the equity effect in the modern corporation. Hatfield & Sprecher, *supra* note 133, at 116. In addition, it may be that the force generated to reduce inequity is more likely to be found in persons who feel they have been underpaid.

150. Adams, *Toward an Understanding*, *supra* note 133, at 424-25.

151. Klein, *The Modern Business Organization*, *supra* note 14, at 1543.

> agers are understandably and legitimately concerned about control even when only salary is at stake; it can be costly for a manager, even a very good one, to move from one job to another. Thus, managers are likely to have strong financial incentives to perform well, to be free from interference by investors (who are, after all, less skilled in management), and to monitor and control the performance of other members of the management team.[152]

Reliance is placed on labor markets, which will be discussed in the next Section, to assure efficient management of the firm.

This new incentive argument in favor of managerial control is referred to herein as the stakeholders' argument. The stakeholders' argument looks at the degree to which persons or groups have a vested interest in the company to ensure the company's survival and/or its profitability. By comparison, under the incentive-residual rights theory, when shareholders who invest $5,000 in a company are juxtaposed with debtholders who invest $100,000, the shareholders are presumed to have the greater incentive to monitor the company. Under the stakeholders' argument, the debtholders have the greater incentive to work for the survival of the firm. Although shareholders would have the greatest interest in profits, they would, nevertheless, not expend as much energy as debtholders to ensure the survival of the firm.[153] Thus, the definition of "stake" takes into account, among other things, not only the probability of a party's loss when compared with others, but also the amount of the potential loss.

Under the stakeholders' analysis, management does not necessarily have a greater stake (and, therefore, incentive to see that the enterprise is operated efficiently) than employees or shareholders. This is also true when comparing individual top managers to individual shareholders, debtholders, or employees. For example, an employee may be less marketable and have less savings to tide him over to search for another job or to finance a needed career change.[154] Therefore, once the stakeholders' anal-

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152. *Id.* (footnotes omitted).

153. That is, while residual owners are concerned with the "operational efficiency" of the firm, where efficiency is equated with profitability, *id.* at 1540, this does not mean that they have more incentive than others to insure the survival of the firm.

154. A risk of loss analysis has been used as a basis for arguing for employee participation in corporate governance. *E.g.*, Jonsson, *Labour as Risk-Bearer*, 2 CAMBRIDGE J. ECON. 373 (1978); Note, *An Economic and Legal Analysis of Union Representation on Corporate Boards of Directors*, 130 U. PA. L. REV. 919, 928-30 (1982).

ysis is adopted as legitimate, the analysis predicts participation in the governance of the firm by various constituencies in different degrees, changing from time to time.

While the stakeholders' analysis can arguably provide the basis for a normative model for firm governance, the stake of a shareholder, creditor, or employee is not in fact the measure of her control of the firm. As the power model emphasizes in the next section, actual control is shaped by the firm's dependence on the factor of production, not the factor's dependence on the firm.

3. *Agency cost approach*— The second theory relied upon by efficiency model theorists is the agency cost approach, which relies upon labor markets and the natural selection argument, to explain existing governance structures. Like the residual rights approach, the agency cost approach maintains that the governance structure of the modern corporation is efficient. It states that the separation of "ownership" and control naturally "leads to"[155] efficient decision-making systems within the firm (such as the board of directors) that separate the management function ("decision management") from the monitoring function ("decision control").[156] The theory posits that shareholders retain certain decision management and control functions, such as voting on mergers, and "delegat[e]" other functions to the board of directors.[157] The board in turn retains and delegates various functions to internal agents.

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155. Fama & Jensen, *Separation of Ownership and Control, supra* note 14, at 311, 322.

156. "Decision management" includes the "initiation" of decisions (*i.e.*, the "generation of proposals") and the implementation of decisions. "Decision control" includes "ratification," defined not only as "monitoring," but also as the "choice of the decision initiatives to be implemented." *Id.* at 303-04. The agency cost approach maintains that "[w]hen residual claimants have no role in decision control, we expect to observe separation of the management and control of important decisions at all levels of the organization." *Id.* at 309. Moreover, in complex organizations, "efficient decision control, like efficient decision management, involves delegation and diffusion of decision control as well as separation of decision management and control at different levels of the organization." *Id.* at 308.

157. *Id.* at 309, 313. Efficiency advantages for having some separation of ownership and control include utilizing the expertise of individuals who do not have capital to invest in the firm, amassing large amounts of capital to bond fixed payment obligations and to invest in risky assets, decreasing the cost of capital to the firm because investors decrease their risk by diversifying and investing only small amounts in the firm, and decreasing the difficulty and cost associated with obtaining the views of many residual loss bearers on matters affecting the corporation. *Id.* at 305-11. Moreover, according to Professor Klein, residual claims "avoid excessive contractual rigidity and inconsistent promises." Klein, *supra* note 14, at 368 n.3.

Because of the discipline of labor markets, the agency cost approach maintains that managers choose those arrangements of retention and delegation of functions that maximize shareholder wealth. Unlike the incentive-residual rights approach, which focuses on trading by residual rights holders, the agency cost approach relies on the outside and inside labor markets and the board of directors to discipline managers in making these important decisions.[158] The market for corporate control offers "little comfort" to the agency cost theorist.[159] It serves as a court "of last resort,"[160] due primarily to the high costs of takeovers noted earlier in this Article.

According to the agency cost approach, the internal labor market operates through the board of directors, which has naturally "evolve[d] to stimulate the ongoing efficiency of the corporate form."[161] In this market, top executives in the company compete with one another to improve the efficiency of the firm. They bring competing initiatives and information concerning the performance of their superiors and corporate governance matters to the attention of outside board members.[162] The board (or at least its outside members) then serves as an arbiter among top managers[163] or, in cases where the chief executive officer of the company should be dismissed, as a "market-induced mechanism for low-cost transfer of control."[164]

This description of an internal labor market creates a number of problems. The theory ignores the process by which outside directors are selected. Outside directors are generally selected and their tenure determined by the chief executive officer, who is supposed to be responsible to them.[165] Outside board members are often not truly independent, but are economically and psychologically dependent on the chief executive officer.[166] They

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158. Fama, *supra* note 14, at 288, 293-95. The labor markets are also dependent on information provided by the capital markets regarding the abilities of managers.

159. *Id.* at 295.

160. Fama & Jensen, *Separation of Ownership and Control, supra* note 14, at 313.

161. Fama, *supra* note 14, at 295.

162. *Id.* at 293-94; Fama & Jensen, *Separation of Ownership and Control, supra* note 14, at 313-14.

163. Fama & Jensen, *Separation of Ownership and Control, supra* note 14, at 315.

164. Fama, *supra* note 14, at 293.

165. In essence, the monitored are expected to select their own monitors. M. EISENBERG, *supra* note 7, at 164. This apparently does not bother the agency cost theorists. The nomination process is perceived to be properly in the hands of insiders, because of their knowledge and expertise. Fama & Jensen, *Separation of Ownership and Control, supra* note 14, at 314.

166. *Id.* When there is added to this the psychological tendencies of persons in groups to conform, the likelihood of the board of directors serving the functions indi-

are selected because they are able to get along with and serve the chief executive officer's needs.[167] Generally, it is in their best interest not to rock the boat. In addition, the executives, who are expected to bring to the outside board members' attention information concerning the performance of their superiors, and competing initiatives, are also for the most part dependent on their superiors for their jobs and job references.[168]

According to the agency cost approach, subordinates have the incentive to bring problems with their superiors or problems with the governance structure of the firm to the attention of the board because subordinate's future opportunities and wages in the outside labor market are tied to the company's performance.[169] Presumably, the outside labor market evaluates all members of top management by reference to the company's stock price, which supposedly reflects the performance of the top managers and the various initiatives adopted by the board.

Even assuming that stock prices are accurate, they do not give subordinates these incentives. The future opportunities and wages of subordinates are more directly affected by their superiors than by stock prices; stock prices cannot be taken to reflect the merits of a particular subordinate. How, for example, does the outside labor market determine from the company's stock price the marginal production of each manager who has engaged in team production or whose responsibility extends only to particular aspects of the corporation's business?[170]

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cated by the agency cost approach is further diminished. *See* Cox & Munsinger, *Biases in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, LAW & CONTEMP. PROBS., Summer 1985, at 83, 91-95.

167. M. EISENBERG, *supra* note 7, at 147 n.36; M. MACE, DIRECTORS: MYTH AND REALITY 99 (1971).

168. M. EISENBERG, *supra* note 7, at 145-46; M. MACE, *supra* note 167, at 99; ("The vice president inside-director is in a precarious position at a board meeting. He just can't say anything in disagreement with his boss, so what he usually does is sit quietly and wait until he is called upon to speak."). Mace, in his extensive study of boards of directors, observed that "CEO's generally did not want to be challenged at board meetings, especially if subordinates of the CEO were on the board or in attendance at the meeting." Mace, *Directors: Myth and Reality—Ten Years Later*, 32 RUTGERS L. REV. 293, 296 (1979). He also observed that board meetings were often "ritualistic performance[s]" and that "[i]n many companies, it would have been possible to write the minutes of a board meeting in advance." *Id.* at 296.

169. Fama, *supra* note 14, at 293-94; Fama & Jensen, *Separation of Ownership and Control*, *supra* note 14, at 313-14.

170. For a detailed critique of the wage revision process, *see* Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 241-43 (1983). Even if such a wage revision process were efficient, it would not create appropriate incentives for all executives, particularly those near retirement or who receive large severance benefits (such as golden parachutes). Fama, *supra* note 14, at 306.

The outside labor market also cannot effectively provide competition for the existing chief executive officer because substantial information costs are involved in finding companies that will be receptive to a new CEO.[171] In addition, to the extent that managers actually control their own retention and compensation, this aspect of the outside labor market operates fitfully at best. Even if such competition exists, changing a governance structure that grants considerable power to managers is unlikely to be a top priority for new managers.

Unlike the incentive-residual rights approach, the agency cost approach does not maintain that exclusive shareholder representation on the board of directors will always be the most efficient arrangement. According to this approach, "[i]n the team or nexus of contracts view of the firm, one cannot rule out the evolution of boards of directors that contain many different factors of production (or their hired representatives), whose common trait is that their marginal products are affected by those of the top decision-makers."[172] According to the agency cost approach, an alternative arrangement would be tried and naturally selected if it were efficient, but it is not today.

In this regard, the agency cost approach ignores that such an "evolutionary" tendency towards constituency representation may be reflected in the presence on existing boards of banks, investment bankers, and others who provide resources to corporations. Moreover, it ignores legal rules that restrain such evolution: in general, directors may be elected only by shareholders, and they must act in the best interest of shareholders.[173] The agency cost approach then is unsuccessful in providing an "evolutionary" justification for the election of directors only by shareholders and in explaining the efficient governance of the firm.

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171. Alchian & Demsetz, *supra* note 14, at 781.

172. Fama, *supra* note 14, at 294. Unlike the incentive-residual rights approach, the agency cost approach maintains that a focus upon joint or team production is too narrow, because "joint production can explain only a small fraction of the behavior of individuals associated with the firm." Jensen & Meckling, *supra* note 14, at 310. Also of interest to the agency cost theorist are relationships with other constituencies, such as suppliers, customers, and creditors.

173. *See supra* note 46 and accompanying text. A discussion of the application of market analysis to lawmaking is beyond the scope of this Article. *See, e.g.*, Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977). Such an analysis has been criticized previously. *See* Coffee, *The Future of Corporate Federalism: State Competition and the New Trend Towards De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759 (1987).

4. *Transaction cost approach*— The third theory offered by efficiency-model theorists to explain existing governance structures is the transaction cost approach. According to this approach, the "main problems of economic organization . . . would vanish"[174] without bounded rationality[175] or opportunism.[176] However, because these factors are present, governance structures are needed and can be explained by reference to three dimensions: uncertainty, frequency, and asset specificity.[177] The first dimension, uncertainty,[178] makes it difficult for parties to foresee and contract adequately with respect to future contingencies. As uncertainty increases, the cognitive limits of individuals are quickly approached, and a greater need arises to provide contractually for governance structures to guard against opportunism. The second dimension, frequency of transactions between parties,[179] justifies the cost of more elaborate governance arrangements among the parties. Asset specificity,[180] the third dimension, measures the degree to which investments made in the context of a relationship cannot be effectively redeployed without a substantial loss in value. As asset specificity increases, the importance of governance arrangements increases to guard

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174. *Id.* at 50. *Accord* Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LITERATURE 1537, 1546 (1981). The main problem of defining property rights under conditions of scarcity, however, would remain.

175. "Bounded" rationality refers to the cognitive limits of individual decision-makers. Within the limits of their cognitive abilities, individuals are perceived to be "intendedly rational". O. WILLIAMSON, CAPITALISM *supra* note 14, at 11 (citing H. SIMON, ADMINISTRATIVE BEHAVIOR xxiv (2d ed. 1961)). *See generally* W. SCOTT, *supra* note 19, at 75, 145.

176. "Opportunism" means "self-interest seeking with guile. This includes but is scarcely limited to more blatant forms, such as lying, stealing, and cheating. Opportunism more often involves subtle forms of deceit. Both active and passive forms and both *ex ante* and *ex post* types are included." O. WILLIAMSON, CAPITALISM *supra* note 14, at 47.

177. O. WILLIAMSON, CAPITALISM *supra* note 14, at 52-61.

178. *Id.* at 56-60.

179. *Id.* at 60-61.

180. *Id.* at 52-56. Asset specificity measures the value of the use of an asset in a particular transaction against its lower value in its next best use (the difference being referred to as quasi-rent). The greater the loss of value, the greater the asset specificity. Four types of asset specificity are defined:

> Site specificity—*e.g.*, successive stations that are located in a cheek-by-jowl relation to each other so as to economize on inventory and transportation expenses; Physical asset specificity—*e.g.*, specialized dies that are required to produce a component; Human asset specificity that arises in a learning-by-doing fashion; and Dedicated assets, which represent a discrete investment in generalized (as contrasted with special purpose) production capacity that would not be made but for the prospect of selling a significant amount of product to a specific customer.

Id. at 95.

against the hazards of opportunism by the other party or parties to the relationship.

The absence of asset-specific investments is reflected in "spot market" trading, where transactions are discrete, and no prior or future relationship exists among the parties.[181] A relationship which began in a competitive or large number context (ex ante) can change to a small numbers condition during the contract, though, because of asset-specific investments made by one or both parties to the relationship during the course of the contract (ex post). In that situation, a bilateral governance arrangement may be set up ex ante to protect asset-specific investments. Bilateral governance arrangements, also called relational contracting, may involve either bilateral structures that maintain the autonomy of the parties, such as arbitration provisions, or unified structures, such as boards of directors or vertical integration.[182] The latter arrangements result in the transaction being brought "within" the firm to become part of an authority relationship.

Under the transaction cost approach, the board of directors is primarily a bilateral governance structure to protect shareholders.[183] In this respect, the transaction cost approach is like the residual rights and agency cost approaches, which describe the board of directors' function as monitoring managers for the benefit of shareholders. The transaction cost approach explains this conclusion, however, by reference to the dimensions of uncertainty, frequency, and asset specificity.

The shareholders' relationship with the corporation is particularly uncertain. The investment by shareholders is made for the life of the firm, making comprehensive ex ante contracting impossible. As for frequency, the shareholder's relationship with the firm is not subject to periodic renewal.[184] Thus, like frequent transactions, the use of an elaborate governance mechanism, such as the board of directors, is cost justified. Shareholders make asset-specific investments, because their investments purportedly are not readily redeployable.[185]

The transaction cost approach also supports board membership for managers. Such membership is designed to protect man-

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181. *Id.* at 73-74.

182. *Id.* at 75-78. *See also* MacNeil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law,* 72 NW. U.L. REV. 854 (1978).

183. O. WILLIAMSON, CAPITALISM *supra* note 14, at 298, 317.

184. *Id.* at 304.

185. *Id.* at 304-07.

agers' asset-specific investments in the firm. According to the transaction cost approach, the board of directors serves "secondarily" to safeguard managers' investments.[186] It is not intended to protect other constituencies. Any other constituency representation would have to be nonvoting and may be efficient only "for the limited purpose of sharing information in a timely and credible manner."[187]

The transaction cost approach is a kind of risk of loss, or stakeholders', theory. This conclusion is suggested by references throughout this literature to "stakes" and "risk of loss" to explain board membership.[188] This approach, though, should not be confused with the stakeholders' argument previously discussed, because the transaction cost approach uses a special definition of stake or risk: A "risk" or "stake" is an asset-specific investment. Accordingly, the transaction cost approach should be judged by its definition of asset-specific investments.

For purposes of reaching various judgments and conclusions in the corporate governance area, the transaction cost approach excludes two important kinds of investments from its definition of asset specificity. First, investments of a personal nature that relate to direct investments by employees in the firm are excluded. The cost of moving, searching for alternate employment, training to be eligible for new employment, and the emotional costs of leaving a community, home, or friends appear not to matter in determining an employee's stake in a job. According to the transaction cost approach, human asset specificity exists only to the extent that an employee has learned skills for his job that he cannot use elsewhere without a substantial loss in wages.[189] Therefore, governance arrangements are efficient only to safeguard this narrow kind of investment.

Second, investments made prior to the transaction in question, or prior to the time the relationship with the firm was established, are excluded from the definition of asset specificity. For example, it is said that suppliers may obtain membership on the board for informational purposes only "where a large volume

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186. *Id.* at 298.

187. *Id.* at 298.

188. For example, board membership for debt holders may be efficient, according to this approach, when their "exposure to risk increases," *i.e.*, when the firm has a high debt/equity ratio or is experiencing adversity. *Id.* at 307. Board membership by suppliers would be called for only "where a large volume of business is at stake and a common information base is needed to coordinate investment planning." *Id.* at 308; *see also* Note, *Union Representation on Corporate Boards of Directors, supra* note 154.

189. O. WILLIAMSON, CAPITALISM *supra* note 14, at 95, 302 n.5.

of business is at stake."[190] Nevertheless, if the firm has alternative sources of supply, the fact that the supplier has a large volume of business at stake does not make board membership any more likely for the supplier under transaction cost reasoning. Only when the firm has induced investments by the supplier in connection with a particular transaction can the supplier expect to participate on the board. Therefore, it is the dependence of the firm on the supplier, or the firm's need for the supplier to provide special products or larger quantities of goods generally unavailable in the market, that makes the investments by the supplier asset-specific. The fact that the supplier has made investments in assets that are useful mainly in providing supplies to the firm is irrelevant if the firm has market power as a buyer.

The efficiency attributes of a theory that ignores personal investments and prior investments must be seriously questioned. Transaction costs of individuals seeking new jobs are no less real than other transaction costs and should be integrated fully into any transaction cost theory. Also, individuals or firms rarely contract without having already made sizable investments and without taking into account those prior investments in making new investments. An efficiency theory that does not concern itself with the proper utilization of these resources or the external costs of firm decision making can have only limited value.

As the power model will demonstrate, what is important to corporate governance is not the supplier's stake in the company, but the company's stake in the supplier.[191] The transaction cost approach, however, artificially creates a symmetrical situation for bargaining purposes, by relying on the assumptions that all investments are entered into for the first time at the time of the transaction or at the time the relationship with the firm is established. The resulting analysis suggests that persons can privately bargain for their own protection. These assumptions are false, however. The majority of transactions with firms are by individuals and firms that have already made extensive investments in machinery, education, resources, or material, or have few alternatives.

The problem with asset specificity is not only that it excludes consideration of certain kinds of investments, but also that it is a nebulous and variable concept that permits virtually any existing or hypothetical governance arrangement to be justified on

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190. *Id.* at 308.

191. *See supra* text accompanying note 154 and *infra* text accompanying notes 234-42.

some basis. For example, in reaching a desired conclusion, the leading transaction cost theorist at one point suggests that the human asset specificity label may attach to the simple task of pinmaking.[192] At another point, the fact that machinery is not on wheels is used to justify that label.[193] In addition, the amount of investment or the degree to which the asset must be nonredeployable to result in a certain type of governance structure is not specified.[194] Also, no explanation is offered as to why one governance structure is better than another based on the dimensions of asset specificity, frequency, or uncertainty. Why, for example, are customers and the community better served by arrangements other than board membership?[195] No answer is forthcoming that relies upon the central dimensions of the theory. The transaction cost analysis often degenerates into a mundane cost-benefit analysis in which it is presumed that existing governance arrangements are cost-justified or efficient. Under this approach, as well as under the agency cost approach, the natural selection or evolutionary argument ultimately provides the questionable answers.

In order to explain shareholder representation on the board of directors, the transaction cost theory maintains that shareholders make asset-specific investments. The nonredeployability aspect of the asset specificity definition poses difficulty for this analysis. Transaction cost theorists argue that stock investments are nonredeployable because stockholders cannot readily obtain possession of the assets their shares represent,[196] and because the assets represented by shares tend to be nonredeployable—more valuable when used by the firm than by other firms in a next-best use.[197] The latter argument has not yet been proved.

Stock investments, however, are characterized by free transferability. Liquidity is an advantage of stock ownership. Moreover, stockholders do not own shares as an alternative to owning the underlying assets themselves.[198] The transaction cost theo-

192. O. WILLIAMSON, CAPITALISM *supra* note 14, at 211 & n.5.

193. *Id.* at 211.

194. Williamson has himself noted the "excessive degrees of freedom enjoyed by transaction cost economics." *Id.* at 391. *See* I. PFEFFER, ORGANIZATIONS AND ORGANIZATION THEORY, *supra* note 19, at 146-47.

195. O. WILLIAMSON, CAPITALISM *supra* note 14, at 308-11.

196. *Id.* at 304.

197. *See id.* at 305 n.10, 307 (noting that the Modigliani-Miller theorem is at variance with the asset specificity/governance approach).

198. Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 259-62 (1983).

rist responds that stockholders should be treated as a group or class and that, as a class, their investments are not readily redeployable.[199] Nevertheless, the firm itself can be sold. While there are transaction costs associated with selling the firm, these costs are comparable to or possibly less than the termination costs of other constituencies interacting with the firm if these constituencies are also treated as classes or groups. Thus, while I do not assert that shareholders do not have reasons for being represented on the board, including shareholders to the exclusion of other groups as voting members is not supported by this analysis.

The transaction cost approach may have biases. It discounts human investments when compared with capital. As previously noted, personal investments are excluded from the definition of human asset specificity.[200] In addition, a leading transaction cost theorist has expressly stated that human asset specificity can never reach the magnitude or importance of capital asset specificity.[201] The apparent bias against labor is further demonstrated by another statement of the same theorist that one efficiency advantage of agreements with employees over other commercial contracts is that employees can be forced to do things in certain circumstances that they have not agreed to do and that do not fall within their zone of acceptance.[202] Efficient for whom, one wonders. This theorist also stresses that labor membership on the board, for information purposes only, is important for the efficiency of the firm, particularly in periods of adversity when firms are asking employees for givebacks.[203] But there is no mention of the particular importance of board membership during periods of prosperity. To labor, participation in profits during good times is of greater significance. The transaction cost approach thus appears to have a bias against labor,[204] although this bias does not extend to top managers.

Voting membership on the board of directors is perceived as an efficient means for managers to safeguard their asset-specific investments.[205] No reason is given, however, for why top manag-

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199. O. WILLIAMSON, CAPITALISM *supra* note 14, at 304.

200. *See supra* text accompanying note 189.

201. O. WILLIAMSON, CAPITALISM *supra* note 14, 248-49.

202. *Id.* at 249. Professor Granovetter also points out that Williamson refers to Chester Barnard's zone of indifference as a zone of acceptance, "thus undercutting Barnard's emphasis on the problematic nature of obedience." Granovetter, *supra* note 109, at 495.

203. O. WILLIAMSON, CAPITALISM *supra* note 14, at 303.

204. *See also* Putterman, *supra* note 31, at 176.

205. *See supra* text accompanying note 186.

ers are more likely than lower level employees to make asset-specific investments. Possibly because of this weakness, the transaction cost approach offers reasons as to why this representation is efficient not only for managers, but also for shareholders.[206] When managers participate in decision making at the board level, outside board members, it is asserted, can observe managers engaging in the process of decision making, which enables the members to better evaluate these managers. In addition, it is argued that outside board members will gain more information by discussing matters at the board level with top managers than by listening to their formal presentations before the board. Both of these objectives, however, can be achieved through non-voting participation by managers at board meetings.

Employee participation on the board can also be efficient from the shareholders' point of view. Labor representatives may be preferable to outside directors, for example, because they can provide an effective counterweight to the power of managers.[207] Labor representatives are not drawn from the same socioeconomic class as outside directors,[208] can spend more of their time on company matters,[209] have a greater "stake" in the company, and have independent access to information concerning the company. As far as shareholders are concerned, labor representatives may, therefore, be more effective watchdogs.[210] In addition, labor representatives can provide outside directors with a new channel of information concerning the company, or a "window out" on the plant.[211] Moreover, any conflict of interest that

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206. O. WILLIAMSON, CAPITALISM *supra* note 14, at 317.

207. Note, *Employee Codetermination: Origins in Germany, Present Practices in Europe, and Applicability to the United States*, 14 HARV. J. ON LEGIS. 947, 993-95 (1977) [hereinafter, Note, *Employer Codetermination*]; Note, *supra* note 154, at 941.

208. Note, *supra* note 154, at 939 (describing an employee director as not part of the old-boy management network).

209. *Id.* at 941.

210. *E.g.*, Comment, *Broadening the Board: Labor Participation in Corporate Governance*, 34 SW. L.J. 963, 979-80 (1980); Note, *Employee Codetermination, supra* note 207, at 993-95; Note, Union Representation on Corporate Boards of Directors, *supra* note 154, at 940-41.

211. Markham, *Restrictions on Shared Decision-Making Authority in American Business*, 11 CAL. W.L. REV. 217, 251 (1975); Summers, *Codeterminism in the U.S.: A Projection of Problems and Potentials*, 4 J. COMP. L. & SEC. REG. 155, 175 (1982); Comment, *supra* note 210, at 979-80. On the other hand, concern has been expressed that the disclosure of confidential information at the board level to employee directors may be harmful to the company. Union officials may have the incentive to disclose information to the rank and file which will justify their position on certain issues. Also, union membership on the boards of competing companies may lead to the disclosure of information that may be competitively disadvantageous to one or more companies. *Id.* at 968; Hopt,

labor may have with respect to matters discussed by the board can be handled in much the same way as managerial conflicts of interest.[212]

This Article offers two other reasons that strongly suggest the efficiency of labor representation on the board from the standpoint of shareholders. One reason relates to the efficiency of lower level participatory arrangements, such as quality circles and teams.[213] These arrangements tend to have longer lives when associated with labor participation at higher levels in the organization.[214] The second reason is that labor participation in corporate governance can increase the corporation's ability to make technological changes. While examples can be found of businesses delaying technological changes due to employee resistance, a strong case can be made that labor participation is effective in facilitating technological change. It lessens conflict with labor by encouraging long-term planning.[215] Three re-

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New Ways in Corporate Governance: European Experiments With Labor Representation on Corporate Boards, 82 MICH. L. REV. 1338, 1358 (1984); Summers, *supra*, at 181; Note, *Employee Representative on the Corporate Board of Directors: Implications Under Labor, Antitrust, and Corporate Law*, 27 WAYNE L. REV. 367, 386 (1980) [hereinafter Note, *Employee Representative*]. Problems associated with interlocking directorates exist with respect to other representatives on current boards, and are not limited to employee directors. Such problems can be largely handled by having employees, not unions, select representatives to the board. Conard, *The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law*, 82 MICH. L. REV. 1459, 1478 (1984). The concern with the confidentiality of information at the board level has been adequately dealt with by other legal systems and is, therefore, resolvable. Hopt, *supra*, at 1359-62 (Collective bargaining in Sweden extends to determining what information will be kept secret. In Germany, the board decides what information will remain confidential). Moreover, access by employee directors to information may contribute to making collective bargaining more rational. Summers, *supra*, at 184.

212. Conard, *supra* note 211, at 1478. An alternative, to minimize any potential legal problems, is for the labor representatives not to participate in decision making at the board level on issues directly involving labor negotiations and disputes. Summers, *supra* note 211, at 169; Note, *Employee Representative*, *supra* note 211, at 390. Similar rules apply in foreign systems where employees abstain from voting at the board level on labor issues. Hopt, *supra* note 211, at 1349-50 (discussing Ireland and Denmark), Note, *Employee Codetermination*, *supra* note 207, at 979 (discussing Sweden). One writer proposes more liberal standards for union directors when deciding upon employee-related matters. Note, *supra* note 154, at 950.

213. Stone, *Public Interest Representatives: Economic and Social Policy Inside the Enterprise*, in CORPORATE GOVERNANCE AND DIRECTORS' LIABILITIES (K. Hopt & G. Teubner eds. 1984); Summers, *supra* note 211, at 185.

214. Note, *Employee Codetermination*, *supra* note 207, at 992-93; *cf.* R. KATZELL & D. YANKELOVICH, *supra* note 115, at 36-37 (stating that system-wide changes can have more positive effects on productivity).

215. *See* E. JACOBS, S. ORWELL, P. PATERSON & F. WELTZ, THE APPROACH TO INDUSTRIAL CHANGE IN BRITAIN AND GERMANY (1978). This is a study of large corporations in Britain and Germany concerning how managers and employees respond to major changes such as large reductions in workforce, reorganization of plants, or movements of produc-

searchers who compared the ability of companies in Great Britain and Germany to make technological changes concluded:

> The execution of technical and organisational change is facilitated by cooperative conflict resolution, which simultaneously ensures the adoption of manpower policies that reduce the element of controversy from industrial change, and so help to expedite it.[216]

In responding to the argument that labor participation on the board is efficient for shareholders, a transaction cost theorist has written:

> If true, the question arises of why some perceptive shareholders have not recognized the benefits and made provision for union participation. Is it ignorance of the gains? Are incumbent managements so well entrenched that they can defeat any such effort? Or are the gains offset by unacknowledged costs?[217]

The legal framework is very important.[218] In the United States, under most state laws, shareholders may not provide in charters or bylaws for the election by employees of employee board members.[219] Moreover, they do not have the right to nominate employee directors to be included in the company's proxy statement.[220] This means that they must engage in a costly proxy contest to nominate employee directors.

The Securities and Exchange Commission has also declined to require companies to adopt procedures for considering director nominees suggested by shareholders.[221] In addition, shareholders

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tion from one site to another. In Britain, where a rights approach has been adopted, reduction in the size of the workforce by a company was associated with firings, so there was acute worker anxiety about technological change. In Germany, where the emphasis is on building cooperative institutions at the enterprise level with, among other things, employee directors, long-term personal planning was undertaken. Reductions in workforce were accomplished through such techniques as early retirement, halt in recruitment, and redeployment of employees within the enterprise. Dismissals were avoided, which resulted in less anxiety among workers about technological change. *See* Note, *Employee Codetermination*, *supra* note 207, at 960.

216. E. JACOBS, S. ORWELL, P. PATERSON & F. WELTZ, *supra* note 215, at 102.

217. O. WILLIAMSON, CAPITALISM *supra* note 14, at 304 n.7. Note that employee participation does not necessarily entail union participation.

218. E. JACOBS, S. ORWELL, P. PATERSON & F. WELTZ, *supra* note 215, at 109.

219. *See supra* note 46.

220. 17 C.F.R. § 240.14a-8(c)(8) (1988).

221. In 1980, the staff of the Securities and Exchange Commission issued a report recommending that, "If there is not a substantial increase in the percentage of companies with independent nominating committees who consider shareholder nominations,

may not include a proposal in a company's proxy statement recommending that the board nominate a certain number of employee directors.[222] The SEC only requires a company to include proposals in its proxy statement that relate to general qualifications for directors and general procedures to be followed in connection with the selection of nominees.[223] The qualifications must apply to all directors equally, and the procedures may not involve consideration of nominees from different groups. The only proposal that would arguably be acceptable, then, would be one that recommended that *all* directors be employee directors.[224] In addition, legal uncertainty concerning potential viola-

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the Commission should authorize the staff to develop a rule requiring companies to adopt a procedure for considering shareholder nominations." SEC ACCOUNTABILITY REPORT, *supra* note 9, at 131. After monitoring the number of companies with nominating committees in connection with its three-year (1979-81) Proxy Disclosure Monitoring Program, the staff decided not to recommend such a rule. By 1981, however, fewer than a third of the companies in its sample had nominating committees (an increase from 19.4% in 1979), and only 78% of these committees considered shareholder nominees, a decrease from the percentage that did so in 1979. Analysis of Results of 1981 Proxy Statement Disclosure Monitoring Program, Exchange Act Release No. 18,532, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,120 (Mar. 3, 1982). *But see* note 224.

222. *See* Harper & Row Publishers, Inc., SEC No-Action Letter (May 9, 1985) (WESTLAW, Securities library, FSED-NAL file) (shareholder recommendation that the board of directors nominate at least one active employee, selected by participants in the company's profit-sharing or employee stock plan, excludable under Rule 14a-8(c)(8)); CNA Financial Corp., SEC No-Action Letter (Feb. 5, 1984) (WESTLAW, Securities library, FSEC-NAL file); Allied Corp., SEC No-Action Letter (Jan. 5, 1984) (WESTLAW, Securities library, FSEC-NAL file) (proposal that one member of the board be a non-management salaried employee excludable under Rule 14a-8(c)(8)); Braniff International Corp., SEC No-Action Letter (Feb. 5, 1982) (WESTLAW, Securities library, FSEC-NAL file) (proposed amendment of bylaws that board of directors nominate at least four active employee shareholders, selected by designated employee groups, excludable under Rule 14a-8(c)(8), because the proposal would require that "employees from certain specified employee groups be included in management's slate of nominees"); Pacific Gas & Electric Co., SEC No-Action Letter (Feb. 12, 1979) (WESTLAW, Securities library, FSEC-NAL file). *But see* American Telephone & Telegraph Co., SEC No-Action Letter (Jan. 14, 1977) (WESTLAW, Securities library, FSEC-NAL file). *See also infra* note 257.

223. *E.g.*, General Motors Corp., SEC No-Action Letter (Mar. 31, 1988) (WESTLAW, Securities library, FSEC-NAL file) (proposal recommending that all directors and nominees for directors own at least $25,000 of Company common stock not excludable under Rule 14a-8(c)(8)); Unicare Services, Inc., SEC No-Action Letter (May 13, 1980) (WESTLAW, Securities library, FSEC-NAL file) (proposal that no director be an officer, director, or principal stockholder of any supplier or customer doing more than $20,000 business with the company not excludable under 14a-8(c)(8)). *But see* Quaker State Corp., SEC No-Action Letter (Mar. 17, 1988) (WESTLAW, Securities library, FSEC-NAL file) (proposal that only company outside directors own common shares for a certain amount not excludable). *See also* note 257.

224. The SEC has also recently permitted a shareholder to include a proposal in the company's proxy statement recommending that the board of directors institute a mechanism for the nomination of opposition directors. Chittenden Corp., SEC No-Action Letter (Mar. 10, 1987) (WESTLAW, Securities library, FSEC-NAL file). Such a proposal, if approved by shareholders and adopted by the board of directors, could result in the cost-

tions of labor and antitrust laws provides further barriers to labor membership on boards.[225]

Under the transaction cost approach, a number of efficiency arguments against constituency representation (including employee representation on boards) are made. This approach points to the deflection of decision-makers at the board level from their main purpose to discussing operating-level complaints; the dissipation of firm assets on "worthy" causes; and "opportunism," or the leverage provided constituencies through board membership to obtain favorable terms in their contractual relationships with the firm.[226] These consequences are neither unavoidable nor necessarily disadvantages of constituency representation on the board. While these arguments will be addressed in this section, additional matters relevant to constituency representation on boards will be deferred to Part V B of this Article.

Concern by the board for what is happening at the operating level may lead to better monitoring of managerial behavior. The board is not in a very good position to determine broad policies for the corporation without considering the operational consequences. Moreover, a disadvantage of the present system is that management largely determines the agenda for board meetings.[227] If constituency board members were to bring operating problems to the attention of the board, the board would be able to determine its own agenda.

The transaction cost theorist assumes that the assets of the firm are used efficiently only when their use benefits shareholders. Therefore, the use of funds for "worthy causes," such as abating pollution caused by the firm's plant or improving working conditions, would be a dissipation of the firm's assets, unless this use of funds was required by law or dictated by contract terms (regardless of bargaining positions or market conditions). To the extent that worthy causes involve the internalization of

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effective nomination of employee directors by shareholders. This letter may very well signal a liberalization of the SEC's views on matters relating to shareholder use of the company's proxy statement. *Compare* Mobil Corp., SEC No-Action Letter (Feb. 19, 1988) (WESTLAW, Securities library, FSEC-NAL file) (proposal recommending that certain shareholders have right to make opposition statements to management proposals in company's proxy statement not excludable) *with* Detroit Edison Co., SEC No-Action Letter (Feb. 12, 1980) (WESTLAW, Securities library, FSEC-NAL file) (proposal for fair and equal debate on proposals in proxy statement excludable).

225. *See* Comment, *supra* note 210; Markham, *supra* note 211; Note, *Employee Representative*, *supra* note 211.

226. O. WILLIAMSON, *supra* note 58, at 311.

227. Coffee, *supra* note 141, at 1190 n.128.

external costs of the business, however, the firm's assets are being used efficiently. Such decisions by the constituency board would increase the efficient utilization of the firm's resources. Only when the firm's assets are used for purposes having no connection with the firm's business can it be said that a dissipation of assets (from the efficiency point of view) occurs. Employees, however, would have no greater incentive than managers or shareholders to use the firm's assets in this way.

From the standpoint of opportunistic behavior, it is better to have a number of constituencies present on the board rather than one, namely management. Each constituency can then keep the others in check. As previously discussed, an employee director can serve as a counterweight to managerial power.

In conclusion, the transaction cost approach fails to make a persuasive case for the efficiency of existing governance structures when it engages both in an asset-specificity analysis and in a mundane cost-benefit analysis.

B. Power Model

This section is devoted to understanding firm behavior with a focus on power as opposed to efficiency. Resource dependence and institutional factors are important to understanding power and the relationship between the firm and various constituencies. This section begins with a discussion of resource dependency and institutional factors. A power analysis of the shareholder-management relationship is then attempted. First, shareholder rights, particularly voting rights, are explored in the context of strategies for avoiding dependencies. Second, the efficiency model's treatment of the board as a device permitting shareholders to monitor managers and thereby enhance the efficiency of the firm is replaced with an understanding of the board as a tool of management, which serves to legitimate the substantial amount of power in the hands of management. Following this section, the efficiency and power models are compared.

1. Introduction— The power model adopts the power coalition view of decision making within the firm.[228] Changes in the corporate governance of a firm, whether intradepartmental or at the board level, can be seen as the outcome of a contest for control. The important questions to ask in connection with such

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228. *See supra* text accompanying notes 25-30.

changes are who gains and who loses. These changes determine firm objectives or the criteria the firm will seek to satisfy.[229] As previously noted:

> A quite different view of conflict and conflict resolution processes is associated with the [power model], which presumes that intradepartmental conflict is not primarily a product of error, ambiguity, and ignorance but results from quite fundamental divergences in group interests; and that the struggles are not concerned simply with means but concern the goals to be served by the organization.[230]

To understand the determinants of firm behavior, a closer look at power is necessary. In comparing power and efficiency, one writer observes:

> [E]fficiency is more likely to be a special case of power than power a special case of, or dominated by, efficiency. Power is wider in its scope; the sources of power are much broader than the sources of efficiency. Efficiency itself needs interpretation in the light of its 'power content,' and this may be less neutral, and more deeply buried in the rules for measuring efficiency, than it seems to be at first sight.[231]

As previously developed in the section on firm goals,[232] the use of efficiency in the efficiency model has a power content, due to imperfections in the market or the existence of market power. Power is also inherent in the efficiency model because the model

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229. Professor Pfeffer explains:

> If we take seriously the conceptualization of organizations as coalitions, then a critical issue is not just what the consequences of various structural arrangements are, but who gains and who loses from such consequences. Structure, it would appear, is not just the outcome of a managerial process in which designs are selected to ensure higher profits. Structure, rather, is itself the outcome of a process in which conflicting interests are mediated so that decisions emerge as to what criteria the organization will seek to satisfy. Organizational structures can be viewed as the outcome of a contest for control and influence occurring within organizations.

J. Pfeffer, *The Micropolitics of Organizations*, in ENVIRONMENTS AND ORGANIZATIONS 25, 36 (1978).

230. W. SCOTT, *supra* note 19, at 248.

231. Turk, *supra* note 80, at 196.

232. *See supra* Part III; McGuiness, *Markets and Hierarchies: A Suitable Framework for an Evaluation of Organizational Change?*, in POWER, EFFICIENCY AND INSTITUTIONS 180, 183 (1983); Turk, *supra* note 80, at 196.

is not concerned with the distribution of wealth or the sources of buying power. In fact, as previously noted, the efficiency model's failure to consider wealth distribution may also make it a less complete model of efficiency.[233]

One way of looking at power in the corporate governance context is to draw upon an expanded version of the resource dependency perspective. From this perspective, power is the obverse of dependency.[234] The "dependence of one party provides the basis for the power of the other . . . ."[235] According to this perspective, the amount of external influence obtainable by various coalitions, such as shareholders, suppliers, or employees, will roughly depend on the corporation's perceived dependence on the resources provided by these constituencies. These resources may be physical goods, capital, labor, or social legitimacy.[236]

In the power model, the corporation behaves so as to increase its area of discretion or to decrease the influence of external organizations and constituencies.[237] Unlike a wheat market, the corporation may utilize various strategies to avoid dependence or to manage its interdependence with its environment.[238] The corporation will tend to focus on areas of critical resource dependencies, because that is where the possibility of external influence over the corporation is the greatest.

The extent of the corporation's dependence on other constituencies depends to a large degree on its ability to alter its conduct in order either to modify its environment or to avoid such dependencies. It can, for example, make different arrangements

233. *See supra* text accompanying notes 149-50.

234. W. SCOTT, *supra* note 19, at 116.

235. Emerson, *Power-Dependence Relations*, 27 AM. SOC. REV. 31, 32 (1962). Building on Emerson's framework, Thompson concluded that: "[A]n organization is dependent on some element of its task environment (1) in proportion to the organization's need for resources or performances which that element can provide and (2) in inverse proportion to the ability of other elements to provide the same resource or performance." J. THOMPSON, *supra* note 19, at 30. A similar formulation has been used to understand power within the organization itself. Hickson, Astley, Butler & Wilson, *supra* note 19, at 159-60. Under this view of power, the exchange relationship need not be zero-sum, with one party losing and the other gaining power. *E.g.*, J. THOMPSON, *supra* note 19, at 31. Through the coordination of their activities, both parties may increase their dependence on the other party. The power need not be symmetrical, however, since one party may be more dependent on the exchange than the other: "[A] symmetry exists in the relationship when the exchange is not equally important to both organizations. This may occur because the organizations differ greatly in size, so that what is a large proportion of one's operations is a small proportion of the other's."
J. PFEFFER & G. SALANCIK, *supra* note 19, at 53.

236. J. PFEFFER & G. SALANCIK, *supra* note 19, at 43.

237. *E.g.*, ; J. PFEFFER, *supra* note 19, at 192-93, 261; W. SCOTT, *supra* note 19, at 116; *see* J. GALBRAITH, *supra* note 7 (suggesting that organizations seek to avoid competition).

238. *See infra* text accompanying notes 247-307.

with these constituencies or absorb them. These strategies may have the effect of decreasing the uncertainty facing the corporation. Certainly, obtaining a market position so that its suppliers become dependent on it rather than the other way around is one such strategy. Going private to avoid tender offers by shareholders or subcontracting work outside the firm, thereby decreasing dependence on the internal labor force, are other strategies. Power as defined by the power model is the ability to organize and structure the activities of other social actors for one's own interests.[239] Rather than describing the firm as largely reactive to various market forces, and its behavior as a result of a complex equilibrium process, the power model suggests that the corporation is proactive. The corporation seeks to affect its social, economic, and legal environment to better meet its needs.[240]

This resource dependency perspective is an expanded version of such perspective for two reasons. The resources that are the focus of corporate efforts are not only capital or physical products, but are also social products, such as social legitimacy. In addition, dependence is not only measured by reference to the concentration of resource control and resource importance, but also by discretion over resource allocation and use.[241]

Discretion over resource allocation and use may provide the sole source of power. This discretion over resources may result from possession of the resource, the actual use of the resource, access to the resource, or the ability to control its use.[242] The ability to control resource use is provided in contract terms and in the recognition of certain property rights by the legal system.

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239. *See* Bauer & Cohen, *supra* note 98, at 93.

240. J. PFEFFER & G. SALANCIK, *supra* note 19, at 107-08.

241. Professors Pfeffer and Salancik, further refined the concepts developed by Emerson and Thompson, discussed *supra* note 235. They identified three factors as relevant in determining degrees of dependence: concentration of resource control, resource importance, and discretion over resource allocation and use. J. PFEFFER & G. SALANCIK, *supra* note 19, at 46-51. The first factor, concentration of resource control, refers to the availability of substitutes or alternative sources, including the ability of sources to organize or coordinate their activities vis-a-vis the corporation. *Id.* at 50-51; *see also*, Jacobs, *supra* note 19, at 56. The second factor, resource importance, is defined as having two dimensions: (i) the relative magnitude of the exchange or the "proportion of total inputs or proportion of total outputs accounted for by the exchange," J. PFEFFER & G. SALANCIK, *supra* note 19, at 46; and (ii) the criticality of the resource or the "ability of the organization to continue functioning in the absence of the resource or in the absence of the market for the output," *id.* at 46. A resource may be critical, although it does not represent a large portion of the corporation's budget (its magnitude is not great), and its importance may vary from time to time. The third factor is discussed in the text of this article. *See* text accompanying note 242.

242. J. PFEFFER & G. SALANCIK, *supra* note 19, at 47-50.

However, "not everything in organizations is [resource] dependence."[243] Institutional factors, such as hierarchy, routine organizational process, control over information flow, and custom may also be sources of power.[244]

A corporation's dependencies produce uncertainties for those in power within the organization because the actions of third parties become important to their survival. The internal managerial coalition can decrease these uncertainties either (1) by diminishing the effect of other coalitions on corporate decision making (i.e., by "avoiding dependencies"),[245] or (2) by altering the corporate environment through various "bridging strategies."[246]

2. *Shareholder rights understood in the context of strategies for avoiding dependencies*— Management may "avoid" certain dependencies by the following: (a) controlling the generation of demands made upon the corporation by coalitions, (b) limiting access by coalitions to communication channels, (c) increasing the cost of communications by coalitions, (d) creating the illusion of satisfying the demands of coalitions, and (e) failing to disclose information to coalitions concerning corporate behavior.[247] Shareholder legal rights can be understood in the context of strategies for avoiding dependencies.

Management has been successful in controlling the generation of demands by shareholders and limiting their access to communication channels. Favorable legal rules restrict the ability of shareholders to bring derivative actions,[248] grant broad discretion to the decisions of directors,[249] and limit the kinds of proposals that shareholders may include in the corporation's proxy statement.[250] In addition, as revealed in the Securities and Exchange Commission's Staff Report on Corporate Accountability, access to management is limited by some companies that do not require directors to attend annual shareholder meetings, limit

243. Hickson, Astley, Butler & Wilson, *supra* note 19, at 160.

244. *See, e.g.*, J. PFEFFER, *supra* note 19, at 239-46; W. SCOTT, *supra* note 19, at 141-43; Hickson, Astley, Butler & Wilson, *supra* note 19, at 160-61.

245. *See, e.g.*, J. PFEFFER & G. SALANCIK, *supra* note 19, at 95-110.

246. *See, e.g.*, J. PFEFFER, *supra* note 19, at 106-09; W. SCOTT, *supra* note 19, at 193-203.

247. J. PFEFFER & G. SALANCIK, *supra* note 19, at 97-106.

248. *E.g.*, *In re* Kaufman Mutual Fund Actions, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973) (demand requirement); Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (demand requirement); FED. R. CIV. P. 23.1 (contemporaneous ownership requirement); DEL. CODE ANN. tit. 8 § 327 (1983) (contemporaneous ownership requirement); *see also infra* text accompanying notes 253-56.

249. *See infra* text accompanying notes 340-41.

250. 17 C.F.R. § 240.14a-8 (1988).

the time directors will be present at such meetings to respond to questions, hold such meetings at inconvenient places, unduly restrict the time devoted to the presentation and discussion of shareholders' proposals, and schedule few regional meetings, although shareholders are dispersed geographically.[251] These strategies all serve to control the generation of demands by shareholders, mainly by limiting their access to communication channels such as the courts, the company's proxy statement, and the annual shareholders' meetings.

The internal managerial coalition's dependence on shareholders is also decreased when the shareholders' cost of communicating demands is increased. Again, favorable legal rules increase the expense of shareholder action. Shareholders may not use the company's proxy statement to nominate directors, but must engage in an expensive proxy contest.[252] Shareholders' expenses in a proxy contest often include the cost of litigating to obtain a shareholders' list[253] and the cost of hiring a proxy soliciting firm. While management may use the company's funds, the shareholder does not have the right to obtain reimbursement for such expenses.[254] Derivative actions also are made more expensive by those states that require plaintiffs to post security[255] and by the ability of firms to terminate derivative actions on the basis of decisions of independent litigation committees made during the pendency of such actions.[256]

While the federal proxy rules decrease the cost of some shareholder communications, costly legal counsel is often required to deal with the considerable technical requirements of these rules.[257] Moreover, certain kinds of communications are not per-

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251. SEC ACCOUNTABILITY REPORT, *supra* note 9, at 138-88.

252. M. EISENBERG, *supra* note 7, at 109 n.48, 112 (Moreover, "incumbents gain an important psychological advantage in soliciting under the name of 'the corporation' rather than under their own names, as insurgents must do.").

253. *See* State *ex rel* Pillsbury v. Honeywell, Inc., 291 Minn. 322, 191 N.W.2d 406 (1971); M. EISENBERG, *supra* note 7, at 112; Comment, *Protecting the Shareholders' Right to Inspect the Share Register in Corporate Proxy Contests for the Election of Directors*, 50 S. CAL. L. REV. 1273 (1973).

254. M. EISENBERG, *supra* note 7, at 122 n.88.

255. *E.g.*, N.J. STAT. ANN. § 14A:3-6(3) (West 1969 & Supp. 1988); *see* Gimbel v. Signal Companies, Inc., 316 A.2d 599 (Del. Ch.), *aff'd* 316 A.2d 619 (Del. 1974) (dismissing plaintiff's action for inability to post $25 million bond); Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 314 (1981) (The "security for expenses statute fails adequately to distinguish between meritorious and nonmeritorious actions and thereby chills both.").

256. *See, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Auerbach v. Bennett, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979).

257. *See* Exchange Act Release No. 20,091, 1983-84 Fed. Sec. L. Rep. (CCH) 83,417 (Aug. 16, 1983) (Commissioner Longstreth's dissent). The technical requirements of

mitted, which have the effect of increasing the cost of shareholder communication. For example, a shareholder may not include in the company's proxy statement a recommendation that the company assist shareholders in forming a shareholders' association that can more effectively voice shareholder concerns even if no special funding is requested from the company to support the association.[258] The efficiency model would increase these

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these rules can be demonstrated by the following. Assume that a shareholder submits a proposal that "a nonmanagement shareholder be elected to the board of directors at the upcoming meeting." This proposal would be excludable under 17 C.F.R. § 240.14a-8(c)(8) [hereinafter Rule 14a-8(c)(8)], which permits the omission of proposals "relating to the election to office," since the proposal applies to the upcoming meeting. Allied Corp., SEC No-Action Letter (Jan. 5, 1984) (WESTLAW, Securities library, FSEC-NAL file); Braniff Int'l Corp., SEC No-Action Letter (Feb. 5, 1982) (WESTLAW, Securities library, FSEC-NAL file). If revised to apply only to subsequent meetings, it would nevertheless be excludable under Rule 14a-8(c)(6), because the proposal is worded such that it is beyond the power of the corporation to effectuate. Management cannot "elect" a nonmanagement shareholder to the board; it can only "nominate" candidates, who in turn must be elected by shareholders. American Information Technologies Corp., SEC No-Action Letter (Dec. 13, 1985) (WESTLAW, Securities library, FSEC-NAL file) (proposal that at least one elected member of the board of directors be a worker-shareholder or retired employee omitted); GTE Corp., SEC No-Action Letter (Jan. 10, 1984) (WESTLAW, Securities library, FSEC-NAL file) (proposal that a number of women should be elected to the board of directors excluded). Then, if the shareholder amends the proposal to provide that "a nonmanagement shareholder be *nominated* to the board," the proposal may be excludable under Rule 14a-8(c)(1), as the proposal is not phrased as a recommendation or request. Northwest Airlines, SEC No-Action Letter (Mar. 2, 1978) (WESTLAW, Securities library, FSEC-NAL file). The SEC, however, would probably point out this error to the shareholder and permit her to amend the proposal. Even so reworded, the proposal may be excludable under Rule 14a-8(c)(8), as it is deemed to relate to the nomination of persons from a "specific group." *See supra* note 222. That is, it does not involve establishing a general qualification for all of the directors. The shareholder can escape this result only by proposing that all nominees be nonmanagement shareholders, *supra* note 223, or possibly by proposing that the board of directors consider nominees selected by a committee composed of nonmanagement shareholders. *See* Bank America Corp., SEC No-Action Letter (Feb. 7, 1980) (WESTLAW, Securities library, FSEC-NAL file) (proposal that the company facilitate organization of institutional investor committees and consider a list of nominees from such group not excludable under Rule 14a-8(c)(8)). *But see infra* note 258.

258. The Southern Company, SEC No-Action Letter (Feb. 5, 1986) (WESTLAW, Securities library, FSEC-NAL file) (recommendation that poll be taken through company's quarterly report of shareholders interested in organizing a shareholders' association, to be organized at no cost to the company); Northeast Utilities Services Co., SEC No-Action Letter (Mar. 5, 1985) (WESTLAW, Securities library, FSEC-NAL file) (recommendation that board investigate means by which company shareholders can form shareholders' association); Boston Edison Company, SEC No-Action Letter (Jan. 6, 1984) (WESTLAW, Securities library, FSEC-NAL file) (recommendation that company assist in establishing shareholders' association); Middle South Utilities, Inc., SEC No-Action Letter (Mar. 4, 1983) (WESTLAW, Securities library, FSEC-NAL file) (recommendation that company assist in organizing and funding a shareholders' association); Pennsylvania Power & Light Co., SEC No-Action Letter (WESTLAW, Securities library, FSEC-NAL file) (Jan 25, 1982) (recommendation that membership solicitation brochure of shareholders' association be included in company's regular mailing to shareholders).

costs even further by doing away with the federal proxy rules altogether, leaving the decision as to whether shareholders should have access to communication channels to market forces acting upon company managers.[259]

Another way to avoid dependencies is to create the illusion that demands are being satisfied. The legal system is helpful in this regard. While shareholders have the right to elect directors,[260] which presumably they want to do, no provision is made under state law for nominations. The election amounts to a vote on one set of nominees selected by management.[261] The illusion is created that shareholders elect directors, which is far from reality. Another example of such an illusion occurs in the area of

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259. Professors Easterbrook and Fischel explain:

> Because it is so easy to sell one's shares, and because managers must set attractive terms for new securities (including terms for voting) if they are to maximize their returns, there is no good reason for believing that the voting rules designed by firms themselves will be inferior to those the SEC can think up.

Easterbrook & Fischel, *supra* note 139, at 421.

According to Professors Easterbrook and Fischel, the federal proxy rules displace private arrangements reflected in state corporation laws. *Id.* at 398. They maintain that there is a "presumption that federal regulation is welfare decreasing." *Id.* at 419. This is not true for state rules that presumably result from efficiency-producing competition among states. *Id. See generally* Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulation*, 53 J. BUS. 259 (1980), Romano, *supra* note 173; Winter, *supra* note 173.

Professors Easterbrook and Fischel argue in favor of shareholder voting rights with respect to the election of directors and on certain major corporate transactions (*e.g.*, mergers) provided under state corporation laws and against proposed nomination rights and existing Rule 14a-8 rights under federal law. The efficiency arguments that they use to support these positions are manipulable and outcome determinative. First, the shareholder's right to elect directors is defended on the basis of the incentive-residual rights theory. Easterbrook & Fischel, *supra* note 139, at 403-06. That theory could also be used in an equally forceful manner to support the right to nominate directors. But since such a right is not provided for by state law, the authors assert that individual shareholders do not have "the appropriate incentive at the margin to study the firm's affairs and vote intelligently," *id.* at 402, and, therefore, choose to delegate this function to management, an "information-generating agency," *id.* at 402-03. This same argument, however, could be used to argue against the individual shareholders' right to elect directors. Second, the absence of a Rule 14a-8 mechanism under state law is explained on the basis that individual shareholders do not have the necessary incentive or expertise. *Id.* at 419-21. These same arguments, however, can be used to support the position that shareholders should not have the right to vote on major corporate transactions such as mergers. In fact, due to the importance and complexity of these transactions, it would appear that the expertise of managers would be even more important for these transactions. But Professors Easterbrook and Fischel, recognizing the difficulty with these arguments, conclude that the fact that these rights have endured creates "a presumption of efficiency that has not been overcome by any contrary evidence." *Id.* at 416. Ultimately, an outcome determinative or natural selection solution is embraced. *See id.* at 397-98.

260. *See supra* note 46.

261. J. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780-1970, at 96-97 (1970); SEC ACCOUNTABILITY REPORT, *supra* note 9, at 131.

auditor selection. Shareholders may vote on the company's auditors.[262] However, shareholders may not use the company's proxy statement to propose different auditors[263] or even to suggest guidelines for the selection of accounting firms by the board.[264] Even an innocuous proposal that there be "yearly consider[ation of] the practice of rotating the outside auditors with the frequency of rotation to be determined solely by the Audit Committee of the Board" can be excluded from the company's proxy statement.[265] Thus, although shareholders appear to have a say over the selection of the company's auditors, in reality they do not.

The illusion of satisfying demands can also be accomplished through another strategy: control over the definition of what is demanded. Directors, because of their election by shareholders and the fiduciary obligations that they owe to all shareholders, are presumed to be in the best position to know what shareholders want. Proposals relating to matters involving the ordinary business operations of the company, for example, may be excluded from the company's proxy statements.[266] However, subsumed within the ordinary business operations are demands relating to such social issues as abortion, plant closings, smoking, use of watershed lands, and use of Indian land.[267] Other issues

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262. Capital Cities/ABC, Inc., SEC No-Action Letter (Mar. 23, 1987) (WESTLAW, Securities library, FSEC-NAL file).

263. S.S. Kresge Co., SEC No-Action Letter (Mar. 17, 1976) (WESTLAW, Securities library, FSEC-NAL file); Kellogg Company, SEC No-Action Letter (Jan. 23, 1976) (WESTLAW, Securities library, FSEC-NAL file); Payless Drug Store, SEC No-Action Letter (Apr. 11, 1975) (WESTLAW, Securities library, FSEC-NAL file).

264. For example, during 1985-86, proposals were submitted to a number of public utilities to amend their bylaws to provide for the periodic rotation of accounting firms, generally every five or more years, and for the board of directors to give primary consideration to competitive bids (from at least three accounting firms) in selecting the replacement firm. Bank America Corp., SEC No-Action Letter (Feb. 27, 1986) (WESTLAW, Securities library, FSEC-NAL file); Long Island Lighting Co., SEC No-Action Letter (Feb. 20, 1986) (WESTLAW, Securities library, FSEC-NAL file); Pacific Lighting Corp., SEC No-Action Letter (Jan. 6, 1986) (WESTLAW, Securities library, FSEC-NAL file); Consumers Power Co., SEC No-Action Letter (Jan. 1, 1986) (WESTLAW, Securities library, FSEC-NAL file); Pennsylvania Power & Light Co., SEC No-Action Letter (Dec. 30, 1985) (WESTLAW, Securities library, FSEC-NAL file); Pacific Gas & Electric Co., SEC No-Action Letter (Dec. 30, 1985) (WESTLAW, Securities library, FSEC-NAL file).

265. Firestone Fire & Rubber Company, SEC No-Action Letter (Nov. 25, 1980) (WESTLAW, Securities library, FSEC-NAL file).

266. 17 C.F.R. § 240.14a-8(c)(7) (1988).

267. *E.g.*, Kimberly-Clark Corp., SEC No-Action Letter (Feb. 26, 1987) (WESTLAW, Securities library, FSEC-NAL file) (proposal for termination of manufacture of tobacco industry paper and products); Weyerhauser Co., SEC No-Action Letter (Dec. 19, 1986) (WESTLAW, Securities library, FSEC-NAL file) (proposal to give community advance notice of plant closings); Hospital Corporation of America, SEC No-Action Letter (Feb.

which are said to relate to ordinary business operations and which must be left to the board are whether the company should limit executive compensation,[268] enter into golden parachute contracts,[269] tie executive compensation to company earnings[270]

12, 1986) (WESTLAW, Securities library, FSEC-NAL file) (abortion proposal excludable as dealing with ordinary business operations, *i.e.*, determination of medical procedures to be performed at company facilities); American Standard, Inc., SEC No-Action Letter (Jan. 22, 1986) (WESTLAW, Securities library, FSEC-NAL file) (proposal for report describing rationale and effect of two plant closings); Pennsylvania Enterprise, Inc., SEC No-Action Letter (Apr. 12, 1985) (WESTLAW, Securities library, FSEC-NAL file) (proposal prohibiting the sale, lease or other conveyance or development of the company's watershed land); Boeing Company, SEC No-Action Letter (Aug. 12, 1983) (WESTLAW, Securities library, FSEC-NAL file); Gulf Oil Corp., SEC No-Action Proposal (Feb. 4, 1980) (proposal to refrain from uranium mining on Indian burial site). *But cf.* The Boeing Co., SEC No-Action Letter (Feb. 22, 1988) (WESTLAW, Securities library, FSEC-NAL file) (proposal relating to establishment of committee to develop plans for alternative uses of military production facilities not excludable as ordinary business matters); Archer Daniels Midland Company, SEC No-Action Letter (Aug. 14, 1987) (WESTLAW, Securities library, FSEC-NAL file) (proposal prohibiting charitable contribution to organizations promoting abortions not excludable as ordinary business).

268. *E.g.*, GTE Corp., SEC No-Action Letter (Feb. 10, 1986) (WESTLAW, Securities library, FSEC-NAL file) (imposing fixed dollar ceiling on amounts payable to executives in excess of the limitations provided for under the Employment Retirement Income Security Act of 1974); Commonwealth Edison Co., SEC No-Action Letter (Aug. 28, 1985) (WESTLAW, Securities library, FSEC-NAL file) (compensation limited to no more than $200,000 salary paid to the president of the United States); Gulf Oil Corp., SEC No-Action Letter (Feb. 14, 1983) (WESTLAW, Securities library, FSEC-NAL file); American Telephone and Telegraph Co., SEC No-Action Letter (Jan. 28, 1983) (WESTLAW, Securities library, FSEC-NAL file); International Business Machines, SEC No-Action Letter (Jan. 25, 1982) (WESTLAW, Securities library, FSEC-NAL file).

In one such letter, a shareholder sought to limit executive compensation under an Executive Stock Incentive Plan. According to the shareholder, the company's operating earnings before income taxes had declined from $753 million in 1981 to $481.5 million in 1982, to $244.5 million in 1983, and to minus $425 million in 1984. Nevertheless, the Chairman in the dismal year 1984 received $490,000 salary, $200,000 bonus, $58,000 profit sharing, and $23,900 matched savings. In addition, under the Plan, he received $241,000, a total of $1,096,000 in cash or stock, plus stock options for 6,100 shares. He also received 8,000 performance units with a maximum value of $150 per unit, payable in the future. The Chairman's cash compensation received in 1984 exceeded by more than $100,000 his 1983 cash compensation. Likewise, the other four principal officers listed in the 1985 proxy all received more in 1984 than in 1983. The proposal was excludable as involving the ordinary business operations of the company. CIGNA Corp., SEC No-Action Letter (Dec. 19, 1985) (WESTLAW, Securities library, FSEC-NAL file); *see* Nynex Corp., SEC No-Action Letter (Feb. 29, 1988) (WESTLAW, Securities library, FSEC-NAL file) (proposal to limit compensation of non-employee directors); Ohio Edison Co., SEC No-Action Letter (Jan. 9, 1987) (WESTLAW, Securities library, FSEC-NAL file) (proposal for shareholder approval of all future increases in executive salaries and benefits); Southwestern Bell Corp., SEC No-Action Letter (Jan. 7, 1987) (WESTLAW, Securities library, FSEC-NAL file) (proposal to limit annual retainer of non-employee directors).

269. *E.g.*, Georgia-Pacific Corp., SEC No-Action Letter (Feb. 22, 1988) (WESTLAW, Securities library, FSEC-NAL file); Occidental Petroleum Corp., SEC No-Action Letter (Apr. 5, 1985) (WESTLAW, Securities library, FSEC-NAL file); *see also*, Crown Zellerbach Corp., SEC No-Action Letter (Feb. 20, 1986) (WESTLAW, Securities library,

or dividend payments,[271] make loans to officers,[272] or adopt an employee stock ownership plan.[273] The board, it is maintained, is in the best position to speak on behalf of shareholders on these "ordinary business" issues.

Finally, the corporation can withhold information. With disclosure, the corporation becomes subject to the demands of various coalitions and thus is often required to take their perspectives into account when it ordinarily would not do so.[274] An efficiency-model writer who opposes mandatory disclosure explains this effect:

> Requiring firms to disclose their policy with respect to compliance with the environmental laws, violations of regulatory statutes [for the protection of employees or

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FSEC-NAL file) (proposal excluded would also have the effect, if enforced, of causing the company to breach an existing agreement).

270. *E.g.*, Emerson Radio Corp., SEC No-Action Letter (Feb. 29, 1988) (WESTLAW, Securities library, FSEC-NAL file); Chrysler Corp., SEC No-Action Letter (Mar. 28, 1985) (WESTLAW, Securities library, FSEC-NAL file); Pacific Gas & Electric Co., SEC No-Action Letter (Feb. 5, 1985) (WESTLAW, Securities library, FSEC-NAL file); Bendix Corp., SEC No-Action Letter (Jan. 17, 1983) (WESTLAW, Securities library, FSEC-NAL file); *see* Maytag Corp., SEC No-Action Letter (Mar. 3, 1988) (WESTLAW, Securities library, FSEC-NAL file)(proposal to tie compensation of directors to company earnings).

271. *E.g.*, Middle South Utilities, SEC No-Action Letter (Jan. 25, 1988) (WESTLAW, Securities library, FSEC-NAL file); Detroit Edison Co., SEC No-Action Letter (Feb. 26, 1987) (WESTLAW, Securities library, FSEC-NAL file); Ramada Inc., SEC No-Action Letter (Jan. 9, 1987) (WESTLAW, Securities library, FSEC-NAL file); Long Island Lighting Co., SEC No-Action Letter (Mar. 28, 1985) (WESTLAW, Securities library, FSEC-NAL file); Bangor Hydro Electric Co., SEC No-Action Letter (Mar. 18, 1985) (WESTLAW, Securities library, FSEC-NAL file); Justin Industries, Inc., SEC No-Action Letter (Feb. 5, 1985) (WESTLAW, Securities library, FSEC-NAL file); Itek Corp., SEC No-Action Letter (Feb. 8, 1980) (WESTLAW, Securities library, FSEC-NAL file). Even shareholder proposals that recommend amendments to compensation plans originally submitted by managers to shareholders for approval may be omitted. E.I. Dupont De Nemours & Co., Inc., SEC No-Action Letter (Dec. 19, 1985) (WESTLAW, Securities library, FSEC-NAL file); CIGNA Corp., SEC No-Action Letter (Feb. 13, 1985) (WESTLAW, Securities library, FSEC-NAL file); Alexander & Alexander Services, Inc., SEC No-Action Letter (Feb. 7, 1984) (WESTLAW, Securities library, FSEC-NAL file).

272. Major Realty Corp., SEC No-Action Letter (Mar. 19, 1987) (WESTLAW, Securities library, FSEC-NAL file) (proposal not to make loans to officers and directors excludable).

273. Santa Fe Southern Pacific Corp., SEC No-Action Letter (Jan. 11, 1988) (WESTLAW, Securities library, FSEC-NAL file) (proposal relating to institution of ESOP); Western Airlines, Inc., SEC No-Action Letter (Feb. 22, 1982) (WESTLAW, Securities library, FSEC-NAL file) (proposal concerning establishment and funding of ESOP); Hercules, Inc., SEC No-Action Letter (Dec. 7, 1981) (WESTLAW, Securities library, FSEC-NAL file); *see also* Pan American Airways, SEC No-Action Letter (Mar. 8, 1984) (WESTLAW, Securities library, FSEC-NAL file) (proposal for additional contributions to the ESOP).

274. *See, e.g.*, J. PFEFFER & G. SALANCIK, *supra* note 19, at 104-05.

> consumers], or questionable foreign or domestic payments all may affect the willingness of the firm to undertake the conduct at issue. Due to a fear of litigation, adverse publicity, or regulatory intervention, managers may simply decide that the costs of disclosure may exceed the expected benefits from the activity.[275]

The proxy proposal rules permit the utilization of this strategy of withholding information. Proposals recommending preparation and dissemination of reports to shareholders or the formation of special committees to examine particular areas of concern involving the ordinary business operations of the corporation may be excluded from the company's proxy statement.[276] Because shareholders invest in corporations on the basis of the ordinary business of the corporation, this severely limits their ability to discover information that they consider important. Moreover, proposals that recommend that additional financial information be disclosed to shareholders may also be omitted.[277] If the information is not legally required, it need not be disclosed.

3. *Shareholder representation on the board understood as a bridging strategy*— When dependencies cannot be completely avoided through the above-described strategies, the corporation may utilize a number of "bridging strategies" to create a negoti-

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275. Easterbrook & Fischel, *supra* note 139, at 424.

276. *E.g.*, Santa Fe Southern Pacific Corp., SEC No-Action Letter (Jan. 30, 1986) (WESTLAW, Securities library, FSEC-NAL file); American Standard, Inc., SEC No-Action Letter (Jan. 22, 1986) (WESTLAW, Securities library, FSEC-NAL file) (request for report describing rationale for and effects of closing of two plants); General Electric Co., SEC No-Action Letter (Dec. 20, 1985) (WESTLAW, Securities library, FSEC-NAL file) (request for information on company's contributions to U.S. Committee for Energy Awareness); Newport Pharmaceuticals International, Inc., SEC No-Action Letter (Aug. 10, 1984) (WESTLAW, Securities library, FSEC-NAL file) (formation of committee to investigate compensation of management); *see also* American Home Products Corp., SEC No-Action Letter (Jan. 9, 1987) (WESTLAW, Securities library, FSEC-NAL file) (proposal relating to making available transcripts of annual shareholders' meetings).

277. *E.g.*, Santa Fe Southern Pacific Corp., SEC No-Action Letter (Jan. 30, 1986) (WESTLAW, Securities library, FSEC-NAL file) (request for current cost financial statements to determine fair market value of shares); Arizona Public Service Co., SEC No-Action Letter (Feb. 22, 1985) (WESTLAW, Securities library, FSEC-NAL file); Pittsburgh & West Virginia Railroad, SEC No-Action Letter (Mar. 19, 1984) (WESTLAW, Securities library, FSEC-NAL file) (request for appraisal or reevaluation of company properties for purposes of establishing current fair market value of shares); Firestone Tire & Rubber Co., SEC No-Action Letter (Dec. 12, 1979) (WESTLAW, Securities library, FSEC-NAL file) (proposal that financial statements reflect effects of inflation).

ated or changed environment. These strategies include contracting, coopting, and coalescing.[278]

Contracting represents "attempts by organizations to reduce uncertainty by coordinating their future behavior in limited and specific ways, with other units."[279] This strategy involves the "negotiation of an agreement for the exchange of performances in the future,"[280] and includes sequential spot contracts, contingent claims contracts, and incomplete long-term contracts in which various matters are left to arbitration.

Cooptation is "the process of absorbing new elements into the leadership or policy-determining structure of an organization [such as the board of directors] as a means of averting threats to its stability or existence."[281] Cooptation is intended to decrease the uncertainty facing the organization by gaining the commitment and support of the coopted coalition or some other audience, such as the public.[282] "[C]oopting is a more constraining form of cooperation than contracting, for to the extent that cooptation is effective it places an element of the environment in a position to raise questions and perhaps exert influence on other aspects of the organization."[283]

Two kinds of cooptation have been identified—formal and informal.[284] "Formal" cooptation involves "the establishment of openly avowed and formally ordered relationships."[285] This form of cooptation is generally utilized to establish legitimacy or to lend respectability to the authority of a governing group and as a means of providing a mechanism for reaching a relevant pub-

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278. *E.g.*, W. SCOTT, *supra* note 19, at 193-98; J. THOMPSON, *supra* note 19, at 34-36.

279. W. SCOTT, *supra* note 19, at 194.

280. J. THOMPSON, *supra* note 19, at 35.

281. P. SELZNICK, TVA AND THE GRASSROOTS: A STUDY IN THE SOCIOLOGY OF FORMAL ORGANIZATION 13 (1949); J. THOMPSON, *supra* note 19, at 35.

282. M. LACY, COOPTATION: ANALYSIS OF A NEGLECTED SOCIAL PROCESS 73 (1977) (the audience coopted need not be the affected group); Lacy, *A Model of Cooptation Applied to the Political Relations of the United States and American Indians*, SOC. SCI. J., July 1982, at 23, 24-25.

283. J. THOMPSON, *supra* note 19, at 35. Professor Lacy disagrees with Thompson's view of cooptation as being a form of cooperation, because that view assumes a "relationship between two actors of more or less equal power." M. LACY, *supra* note 282, at 20. He constructs a threat model in which cooptation involves yielding by the powerholder in order to soften the impact of a threat to his power. *See also* W. GAMSON, POWER AND DISCONTENT (1968); H. MINTZBERG, *supra* note 19, at 87-88. The threat is defused with a legitimacy payoff and by providing a filter between the powerholder and the threatening group. *See infra* text accompanying notes 291-95, 306.

284. P. SELZNICK, *supra* note 281, at 13.

285. *Id.*

lic.[286] "Informal" cooptation, rather than being public, occurs often in the "shadowland of informal interaction,"[287] so as not to undermine the legitimacy of the governance structure. It is a response to specific individuals or interest groups brought into the policy-determining organ of the company because of the firm's dependence on them for physical resources or funds.[288]

Coalescing involves the combination of organizations by merger or joint venture where the corporation acts as one with a coalition with respect to certain operational goals through joint decision making.[289]

The shareholder-management relationship may be one of coalescing, informal cooptation, or formal cooptation, depending on the nature of the corporation's dependence on its stockholders. As the size and complexity of a company increase, the nature of the corporation's dependence on its shareholders changes.

In the small close corporation, the firm is often dependent on its shareholders for both managerial services and capital. There is coalescing, whereby the shareholders and those who control the corporation share a common identity. Passive shareholders

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286. *Id.* at 259-60. Professor Selznick found an example of formal cooptation in the use of voluntary county associations by the county agents or agricultural extension workers of the land grant colleges. *Id.* at 231-37, 163-64. Avowedly formed to involve local citizens at the grassroots in the TVA's fertilizer test demonstration program, the associations actually served as tools for the agents. For instance, they served as a "front" for the selection of farmers to participate in the program, thus buffering the agents from complaints of "playing favorites," and provided administrative functions involving funds supposedly not within the educational role of the agents. Professor Selznick found that, in many cases, de facto power remained in the agents--the selection of farmers to participate in the program represented simply the formal confirmation of choices of the agents, and, in many cases, the county agents were in complete control of the functions of the associations. Moreover, the associations were not parties to the agreement between the TVA and the extension services establishing the policy governing the fertilizer test demonstration program within the state. Although the agents' control was partially explained by their responsibility for the success of the program, the desire to maintain power was a factor. Some officials at TVA had hoped for the development of a strong cooperative movement based on the network of associations, but it was perceived that "the extension service remained hesitant about organizing unlimited membership organizations for fear that such organizations would 'get out of their hands'." *Id.* at 235.

The associations then served various administrative functions for the agents. However, they were not successful in legitimizing the TVA's program in the area, because the farmers did not view the organization as theirs. Cooptation is not always successful. However, it has been noted by Professor Lacy that legitimacy payoffs may come from an audience outside the system where cooptation occurs. M. LACY, *supra* note 282, at 73. In the case of the TVA, the grassroots association served to legitimize the intrusion of the TVA into the region by those voters supporting the program through their representatives in Congress.

287. *Id.* at 261.

288. *Id.* at 15.

289. W. SCOTT, *supra* note 19, at 196-98; J. THOMPSON, *supra* note 19, at 35-36.

who are brought into the small close corporation to provide a source of present and future capital for the firm add an element of informal cooptation. These shareholders are often a powerful group who pose a substantial threat to management, because smaller firms and, particularly, firms in their formative years have fewer sources of funding available at affordable prices. Moreover, the new corporation lacks a track record and relevant information upon which to judge its operations and its management team, which makes obtaining sufficient financing from other sources, such as bank loans and debt offerings, difficult and expensive.[290]

The large public corporation is less dependent on its shareholders for capital. It has many sources of financing.[291] Thus, the power of shareholders in this context stems less from physical resource dependence than from the social legitimation of managerial power that the inclusion of shareholders in the official decision-making process provides. The one resource that management expects shareholders will provide in the public corporation is social legitimacy. Formal cooptation is involved.

This legitimation[292] derives from three sources. The first source resides in the American respect for private property. Shareholders are generally perceived by the public to be "owners" of the corporation and, therefore, ultimately in control of its activities. Managers thus can argue persuasively against governmental interference by relying for legitimacy on arguments relating to the private control of property. The second source of legitimacy rests on the efficiency argument—made by the residual rights theorists—that owners have the greatest incentive to utilize corporate resources efficiently, which redounds to the benefit of society.[293] A mechanism for owner participation in decision making thus provides a social reason for combating interference

290. *See generally* W. KLEIN & J. COFFEE, BUSINESS ORGANIZATION AND FINANCE (1986).

291. U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE U.S., 547, table 924 (1984); *see* G. DONALDSON, MANAGING CORPORATE WEALTH 42-57 (1984).

292. Legitimation is a means of rationalizing or justifying an organizational structure as being consistent with social values. *E.g.*, J. PFEFFER & G. SALANCIK, *supra* note 19, at 193-202. Legitimacy is not necessarily synonymous with legality or with economic viability, although it bears some relationship to both. *Id.* at 93. That is, legitimacy does not arise merely from economic viability, although if an activity is legitimate to a large enough segment of the population, it will probably be economically viable as well. *Id.* But, although a cocaine operation is able to find persons to support its operations through the exchange of scarce resources, it is not consistent with social values. An organizational structure may likewise be economically viable but lack legitimacy. This may be because it is inconsistent with social norms or values.

293. *See supra* text accompanying notes 117-45; J. HURST, *supra* note 261, at 85.

by government in managerial decision making. The third source of legitimacy is the comfort obtained from a system of "checks and balances"—fundamental to the American understanding of justice—whereby managers are perceived to be checked by shareholder participation.[294] It is generally considered beneficial for those holding positions of power to be held accountable to some group or groups other than themselves. That management is purportedly held accountable to shareholders serves to legitimate its exercise of power. Shareholder participation has thus provided the ideological justification for managerial power.[295] Such a justification is particularly important for the large corporation because of the scope of its control over decisions affecting the community at large.

The relationship between shareholders and management in a large public corporation is then one of formal cooptation. The purpose of formal cooptation is to provide a "front" or "aura of respectability" for the powerholder.[296] This objective is obtained by providing participation by the coopted group in a governance structure, while limiting the ability of that group to exercise true power: the "point of formal cooptation is to share the public symbols or administrative burdens of authority and, consequently, public policy, without the substantive power being transferred."[297] That substantive power is not transferred to the public shareholders is amply demonstrated in the section that

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294. *E.g.*, J. HURST, LAW AND SOCIAL ORDER IN THE UNITED STATES 242, 244 (1977); SEC ACCOUNTABILITY REPORT, *supra* note 9, at 86 (transcript of Professor Carey's testimony); *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2090 (1978)(statement of The Business Roundtable)("It is appropriate, however, that the public and its elected representatives should be concerned that private business organizations like government itself be subject to checks and balances, to constraints on excessive power").

295. *See* R. DAHL, AFTER THE REVOLUTION: AUTHORITY IN A GOOD SOCIETY 125 (1970); J. HURST, *supra* note 294, at 93 (it was by the shareholder's vote that he would formally confer legitimacy on the power wielded by those immediately controlling the firm); SEC ACCOUNTABILITY REPORT, *supra* note 9, at A-4,A-5 (issue raised as to "whether the present corporate governance system [would] retain its legitimacy in the absence of shareholder participation"). The SEC report also stated:

> In this time of increasing competition between business and government over the direction of the economic system, it is important that the legitimacy of the corporate form as a principal means of doing business be supported by the public and that internal corporate practices not be mandated by law or regulating fiat. Confidence in the corporate institution can be increased by better publicizing the role and function of the board of directors. The annual meeting, annual report to shareholders, and proxy statement can be the focal point of this important educational effort.

Id. at 211-12 (quoting AMERICAN SOC'Y CORP. SECRETARIES, ANNUAL MEETING GUIDE 7.

296. P. SELZNICK, *supra* note 281, at 260.

297. *Id.* at 261.

relates to the avoidance of dependencies.[298] One of the most significant obstacles to shareholder control is the right of management to include only its nominees in the company's proxy statements.[299] This method of selecting powerholders is consistent with the traditional model of cooptation, in which members of a governing group are elected by existing members of that group.[300]

Cooptation, however, is not always successful. Nevertheless, when the legitimacy payoff is with a broader audience than the coopted group, the audience is "less likely to critically examine the meaningfulness of expanded participation."[301] This is especially true in the case of shareholder participation in which the public at large is the relevant audience.

Formal cooptation can result in actual sharing of power, such as when a coalition becomes organized and is able to exert real power. This power could be exerted, for example, by the organization of shareholders' associations or the acquisition of large blocks of stock by individual shareholders. In this respect, cooptation is a "two-edged sword."[302] It provides legitimacy for managerial power, but it also has the potential to displace that power.

That managers intended shareholder participation to provide legitimacy for the exercise of their power and not to confer real power is evidenced by the response of managers to tender offers. When large shareholders sought to exercise power through tender offers, managers responded with a vast array of defensive maneuvers.[303] The use of these maneuvers has publicly exposed the enormous amount of power residing in corporate managers. They have tarnished the "aura of respectability" in which managerial power has been cloaked. This unveiling, in turn, has fueled efforts to find other bases of legitimacy for the exercise of managerial power. One response is to legitimize the exercise of power by managers on behalf of constituencies other than share-

298. *See supra* text accompanying notes 247-77.

299. 17 C.F.R. § 240.14a-8(c)(8) (1988).

300. M. LACY, *supra* note 282, at 10-14 (traditional elite recruitment model of cooptation); H. READING, *A Dictionary of the Social Sciences* 50 (1977) (first definition).

301. M. LACY, *supra* note 282, at 72. "There are several possible targets for legitimacy payoffs: the threat group itself [here shareholders], the audience within the system, and the audience outside the system [the public]." *Id.*

302. *E.g.*, W. SCOTT, *supra* note 19, at 195-96 ("Cooptation as a bridging mechanism provides a two-way street with both influence and support flowing sometimes in one direction, sometimes in the other, and more often, in both"); P. SELZNICK, *supra* note 281, at 12; J. THOMPSON, *supra* note 19, at 35.

303. L. RIBSTEIN, BUSINESS ASSOCIATIONS 12-39 (1985).

holders.[304] Another is to defend as legitimate and efficient the issuance of nonvoting common stock.[305]

In the power model, shareholder representation on the board of directors of public corporations is an effective cooptative device.[306] This participatory mechanism legitimizes the power of managers. The board also serves to channel and blunt the exercise of shareholder power.[307] Thus, there is a filtering payoff as well.

4. *Concluding comments*— In the power model, the composition and functions of the board of directors cannot be considered apart from a social, cultural and political context. Although the scarcity of resources is a reality, how these resources will be used and how activities utilizing them will be organized and directed is a matter of social organization. Even the identification of resources as critical for the corporation emerges, in part, through a process of social influence and social definition of the organization. It is culture that devalues women's work over that of men and that of the black over the white man. The organization of the firm as a top to bottom hierarchy is a reflection of

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304. *See supra* notes 17-18; *cf.* J. HURST, *supra* note 261, at 104 (shareholders' own legitimacy at issue).

305. *See* Dent, *Dual Class Capitalization: A Reply to Professor Seligman*, 54 GEO. WASH. L. REV. 725 (1986); Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119 (1987).

306. To my knowledge, the board of directors has not previously been conceptualized as a cooptative device with respect to shareholders. The participation of other constituencies on the board, however, has been viewed in this way. Some researchers have found that directorate ties follow patterns of the corporation's critical dependencies. *See, e.g.*, R. BURT, CORPORATE PROFITS AND COOPTATION (1983); Burt, *Cooptive Corporate Actor Networks: A Reconsideration of Interlocking Directorates Involving American Manufacturing*, 25 ADMIN. SCI. Q. 557 (1980); Pfeffer, *Cooptation and the Composition of Electric Utility Boards of Directors*, 17 PAC. SOC. REV. 333 (1974); Pfeffer, *Size, Composition, and Function of Hospital Boards of Directors: A Study of Organization-Environment Linkage*, 18 ADMIN. SCI. Q. 349 (1973); Pfeffer, *Size and Composition of Corporate Boards of Directors: The Organization and its Environment*, 17 ADMIN. SCI. Q. 218 (1972). *But see, e.g.*, Palmer, *Broken Ties: Interlocking Directorates and Intercorporate Coordination*, 28 ADMIN. SCI. Q. 40 (1983). The number of such members on boards has decreased since the SEC has required that the relationships between directors and other coalitions be disclosed. *See* Analysis of Results of 1981 Proxy Statement Disclosure Monitoring Program, *supra* note 221. This decrease lends support to the position that these ties are a form of informal cooptation. With informal cooptation, the ties must be kept nonpublic, because their disclosure tends to undermine the legitimacy of the governance structure. *See supra* text accompanying note 287. Social legitimacy depends on board members representing shareholders, not the other coalitions.

307. M. LACY, *supra* note 282, at 74-77. Participation within a bureaucratic structure provides a filtering function, consisting of blunting and channelling. Blunting refers to the "low impact on the powerholder allowed by the structure of participation." *Id.* Channelling is the confining of resistance "to that possible through the structure of participation." *Id.*

social, cultural, and political values,[308] just as equally efficient work teams are a reflection of changing social values. Likewise, the composition of the board of directors is a reflection of political and social values.

The power model rejects the evolutionary or natural selection perspective of the efficiency model. The corporation is part of and, in part, creates a socially constructed reality.[309] For the social constructionist:

> The idea that meaning and reality are socially constructed implies that there is no necessary or natural order to social arrangements. Such arrangements, as well as their meaning, are products of human action and cognition. This means that institutionalization and legitimation are themselves processes open to study, debate, and contest. Consequently, all social arrangements are problematic rather than inevitable . . . .[310]

It should be noted that the social constructionist viewpoint is to some extent at odds with the resource dependency perspective, from which one is more inclined to see "some material concrete reality in the pattern of transactions or in the pattern of operations of the organization."[311] Nevertheless, even the resource dependency perspective recognizes that the corporation's behavior is limited by its perceptions. The corporation's behavior in relation to a given coalition depends on its attention process or its re-creation of its environment.[312] These processes in turn are dependent on the corporation's structure, its division into departments or divisions, and the nature of its activities. Bias is present throughout the system. For instance, it is present in the perceptions of administrators. Because persons typically perceive their expertise as more critical to the resolution of the firm's problems than the expertise of others,[313] administrators

308. *Cf.* Francis, *Markets and Hierarchies: Efficiency or Domination*, in POWER, EFFICIENCY AND INSTITUTIONS 105 (1983) ("I try to argue that where hierarchy is chosen in preference to market as a means of conducting transactions, this is not always because it is in some sense technically a more efficient means of transacting, but because it allows one party to dominate the other and act against their interests.").

309. *E.g.*, Bauer & Cohen, *supra* note 98, at 94; J. PFEFFER & G. SALANCIK, *supra* note 19, at 259-60.

310. J. PFEFFER, *supra* note 19, at 210.

311. *Id.* at 220.

312. J. PFEFFER & G. SALANCIK, *supra* note 19, at 71-83, 260; *see also* J. PFEFFER, *supra* note 19, at 219-20.

313. J. PFEFFER & G. SALANCIK, *supra* note 19, at 234-35; W. SCOTT, T. MITCHELL & P. BIRNBAUM, *supra* note 19, at 219-20.

are likely to perceive their contribution to problems to be more valuable even though input from others is often needed to resolve the problems. In addition, administrators tend to perceive the functions they perform as more complex, and to see those below them as less complex and therefore subject to review and routinization.[314] The reward structure and organization of work will then reflect these perceptions.

The various strategies by which the corporation can decrease its dependencies do not alter the amount of interdependence in the system:

> The only changes which alter the amount of interdependence are those which (1) increase the amount of available resources and (2) decrease the number of contenders for those resources. If there is a scarcity of some resource, the fact that one organization stabilizes its acquisition of the resource through some form of social coordination does not alter the fact of the scarcity. It solves one organization's problem by transferring the problem to others.[315]

That is, the corporation's pursuit of uncertainty reduction is not necessarily positive to the system as a whole, due to third party effects. As one writing notes:

> Strategies to manage interdependence require interlocking activities with others, and such interlocking produces concentrated power. Those organizations not involved in the resultant structure are less powerful and less able to cope with their problems of interdependence.[316]

Thus, rather than finding interlocking behavior to be efficient by reference to the possible reduction of transaction costs, the power model recognizes the problematic nature of many such arrangements.

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314. W. SCOTT, *supra* note 19, at 228-32.

315. J. PFEFFER & G. SALANCIK, *supra* note 19, at 284.

316. *Id.* As Professors Pfeffer and Salancik note:

> The problem is that the negotiated environment established is not one that includes the interests of all parties. . . . The problem with collusion, or coordination to establish negotiated environments, is that everyone is not freely and openly participating in the process. Only a few members of a market may be participating, and it is frequently the least powerful and the least organized whose interests are not served in the resultant interorganizational structure.

Id. at 183-84.

C. *Comparison of Efficiency and Power Models Regarding Firm Behavioral Determinants, The Shareholder-management Relationship, and The Board of Directors*

Comparisons of the two models with respect to the topics covered in this part have probably already been made by the reader. For this reason, the models will be only very briefly compared in this section. More importantly, this section focuses on arguments concerning the relative merits of the concepts of efficiency and power in understanding organizational structures.

In the efficiency and power models, firm behavioral determinants differ. In the efficiency model, markets determine firm behavior. In the transaction cost approach, individuals and firms are motivated to minimize transaction costs.[317] Based on a natural selection argument, organizational structures are understood in efficiency terms. By contrast, in the power model, firm behavior is the outcome of a power contest. Power derives from a number of sources, including resource dependency, position in hierarchy, culture, and distribution of wealth. To the extent that the firm has a single motivation, it is to increase power, which is defined as discretion and autonomy.[318] Organizational structures can be explained in a number of different ways under this model.[319]

The efficiency model suggests that the terms of the shareholder-management relationship result from individual contracting. The board of directors emerges under this model as primarily performing a monitoring function on behalf of shareholders. The power model also understands the relationship as an exchange, but as one among groups operating in a

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317. *See supra* text accompanying note 58; Williamson & Ouchi, *supra* note 100.

318. *See supra* text accompanying notes 62-64. Professor Pfeffer, in commenting on the resource dependency perspective, states:

> The resource dependence perspective . . . argues that the principle concern motivating integration is the attempt to reduce uncertainty and that this uncertainty reduction will be pursued even at the expense of profits, albeit subject at some level to a profit constraint when mergers among business firms are considered. Concerned more with issues of power and politics both within the firm and between firms, resource dependence essentially argues . . . from the perspective of power maintenance and power acquisition. Structural autonomy, or freedom from external constraint, and the ability to constrain or affect other firms motivate the various cooptive strategies used by firms. Power may have profit outcomes . . . but profit or efficiency is not the sole or perhaps even the dominant motivating force.

J. PFEFFER, *supra* note 19, at 206.

319. *See supra* text accompanying notes 65-69.

social and political context. The board of directors is, in power terms, a cooptative device with respect to shareholders.[320]

It has been argued that the resource dependency perspective explains outcomes in terms of power when they are more appropriately understood in efficiency terms.[321] Some argue, for example, that a response by an organization to a critical dependency is efficient. Indeed, the resource-dependency theorist often explains such a response as adaptive.[322]

At least a few observations are in order. First, the power model identifies resource dependence as only one source of power, and thus it only partially explains firm behavior. Also, an expanded view of "resources" is utilized. Second, the author of the power model is more sensitive to the social constructionist perspective than some resource dependency theorists. Among other things, the model recognizes room for the exercise of discretion in the identification of dependencies, degrees of criticality, and strategies for avoidance.[323] Also, note that the identity of the firm's dependencies is related to the "choice" of firm goals. Third, the notion of "efficient" adaption to an environment tends to obscure the fact that such adaption can change the environment to which others then must adapt. A change in the environment that benefits one organization may adversely affect another, and such change may not be "efficient" for the system as a whole.[324]

It also has been argued that the power phenomenon is transient and in the long-run will give way to efficiency.[325] Thus, efficiency, rather than power, is more important to an understanding of organizational structures. This, of course, is the natural selection argument, which has been previously criticized.[326] That discussion will not be repeated here, except to reiterate that the argument is highly dependent on competition reaching the uppermost levels of power in an organization. Moreover, conceptually, the long-run must build upon what happens in the short-run, which results in a particular distribution of wealth, organizational structure, and negotiated arrangements. These results will necessarily affect what is considered efficient in the long-

320. *See supra* text accompanying notes 278-307.

321. Williamson & Ouchi, *supra* note 100, at 29-30.

322. J. PFEFFER & G. SALANCIK, *supra* note 19, at 106-07.

323. *See supra* text accompanying notes 312-14.

324. *See supra* text accompanying notes 315-16; Bauer & Cohen, *supra* note 98, at 88.

325. Williamson & Ouchi, *supra* note 100, at 29-30.

326. *See supra* text accompanying notes 90-96.

run. It is, therefore, no surprise that the efficiency model is utilized today, in most cases, to justify power in a few. Note that this is a departure from the competitive market ideal, upon which, ironically, the validity of the model ultimately depends.

It is also argued that efficiency is a more readily defined concept than power, and therefore it is a better concept to use to understand organizational structure.[327] Only by reifying the corporation[328] or viewing it as an instrument for a single interest group, however, can efficiency be defined. It is clear that reification is what is involved when an efficiency theorist argues that "power explains results when the organization sacrifices efficiency to serve special interests."[329] Whose interests does the "organization" serve? As the power model reflects, the ambiguity of goals makes the efficiency analysis problematic.

V. AN EXAMINATION OF SOME BASIC CORPORATE LAW PRINCIPLES FROM THE PERSPECTIVES OF THE EFFICIENCY AND POWER MODELS

In this section, some basic principles of corporate law are examined from the perspectives of the efficiency and power models. The principles examined are: (1) that the objective of the corporation is to enhance corporate profits and shareholder gain and (2) that the board of directors shall be elected by shareholders.

A. *Enhancing Corporate Profits and Shareholder Gain as the Objective of the Corporation*

The American Law Institute's *Principles of Corporate Governance* § 2.01 provides that the principle objective of the corporation is to enhance corporate profits and shareholder gain.[330]

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327. Williamson & Ouchi, *supra* note 100, at 30.

328. *See* Davis, *A Critique of the Ideology of Efficiency*, 12 HUMBOLDT J. OF SOC. REL. 73 (1985).

329. Williamson & Ouchi, *supra* note 100, at 30.

330. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01 (Tent. Draft No. 2, 1984) [hereinafter T.D. 2]; *see* Dodge v. Ford Motor Co., 204 Mich. 459, 507, 170 N.W. 668, 684 (1919). The court in Dodge v. Ford Motor Co. stated:

> A business corporation is organized and carried on primarily for the profits of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain

This legal principle rests on the acceptance of the efficiency model. The efficiency model maintains that the most efficient governance structure of a corporation is one in which shareholder benefit (or profit) serves as the controlling factor in corporate decision making.

Various reasons have been examined for the adoption of this principle. Briefly, shareholders, according to the incentive-residual rights theory,[331] have the incentive to utilize the resources of the corporation most efficiently, because they are the "owners" of those resources and receive only the profits that those resources can produce. Therefore, a corporation managed in a way that shareholders would approve emerges as the standard of efficiency. Under the agency cost approach,[332] shareholder representation on the board is the most efficient governance arrangement for the firm. If it were not, market forces would cause a different arrangement to be utilized. Thus, efficiency is enhanced by having the interests of shareholders ultimately control decision making. Finally, according to the transaction cost approach,[333] shareholders make asset-specific investments in the firm, which presumably can be obtained by the firm only by promising to shareholders that corporations be operated to maximize profits for shareholders. This contractual term then contributes to the viability of the firm and would not exist unless it were efficient.

In contrast, the power model maintains that corporations pursue numerous objectives, sometimes inconsistently. Indeed, this manner of operation is not necessarily "inefficient," but may contribute to the adaptability of the firm to its environment.[334] Implicit in the power model is the notion that the struggles within the firm, and between internal and external coalitions, do not mainly revolve around whether efficient or inefficient methods of operating decisions, or arrangements should be adopted, but on the goals or values to be pursued by the organization. A political model of the corporation is involved in that what re-

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> that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.

Id.

The decision in this case must be understood, of course, with the following in mind: it was decided prior to the social responsibility debates, did not involve an action for damages from directors, and involved a potential freeze-out of the Dodge brothers.

331. *See supra* text accompanying notes 119-45.

332. *See supra* text accompanying notes 155-73.

333. *See supra* text accompanying notes 174-227.

334. *See supra* text accompanying notes 74-78.

sults from the political struggle may be rationalized on efficiency grounds, but more accurately reflects power considerations. If profit is adopted as the objective of the corporation, this conclusion is the result of a power struggle in which certain power coalitions have prevailed.

As noted above, profit maximization may not be synonymous with the best interests of society.[335] In the real world, efficiency is not a neutral concept, as some efficiency theorists would have it, but is value-laden. This is particularly the case when third-party effects are not taken into account. As previously discussed, firms that maximize profits are not necessarily those most likely to survive.[336] Even if those firms were most likely to survive, the utility of "survival" is itself value-laden, depending on one's judgment of the value of the corporation's products, services, and methods of operation. In addition, the maximization of profits for shareholders does not necessarily translate into the enhancement of the value of underlying assets.[337]

A principal justification for the adoption of the profit objective by corporate law scholars is that it supposedly provides "a single, objective, easily monitored [residual] goal."[338] Nothing could be further from the truth. First, the pursuit of profit is not the pursuit of a single goal, but involves decisions and actions in furtherance of numerous goals. Second, it is not objective. What costs and benefits, for example, are to be included in the calculation of profits? If social costs are to be included, how are various social costs and benefits to be valued? How are potential future economic benefits and costs to be quantified given the uncertainty of future markets? Third, it is not an easily monitored goal. How can decision-makers be made accountable on the basis of profit when their decisions involve making predictions of future returns from uncertain markets? How are decisions to be monitored when various business alternatives may be chosen involving different degrees of profit potential, some long-term and others short-term? Finally, how are decisions to be judged when alternatives are available with equal profit prospects? I submit that the only way these decisions can be assessed is on the basis of values other than profit. Fourth, if profit is deemed to be a "single, objective, easily monitored goal," why wouldn't other

335. *See supra* text accompanying notes 81-87.

336. *See supra* text accompanying note 93.

337. *See supra* text accompanying note 142.

338. R. CLARK, CORPORATE LAW 692 (1986).

goals, such as the maximization of employee wages, consumer prices, and survival, do equally as well?

The profit objective is to a large extent a fiction, which hides under the guise of objectivity the substantial amount of discretion managers have to make value choices. This is reflected in the commentaries to the American Law Institute's Draft, which recognize how the selection of time horizons can justify a substantial range of choices by managers:

> Activity that entails a short-run cost to achieve an appropriately greater long-run profit is therefore not a departure from the economic [profit] objective, and an orientation toward lawful, ethical, and public-spirited activity will normally fall within this description . . . . Although the corporate decisionmaker . . . needs to meet a standard of care in making his decisions, that standard can be satisfied even when, as is often the case, a prospective profit cannot be particularized. Recurring cases of this sort include those in which the object of a corporate action is to maintain the confidence of business organizations with which the corporation deals, to foster the morale of employees, or to encourage favorable or forestall unfavorable government regulation—as by abstaining from conduct that would engender unfavorable public reaction against the corporation, providing lawful assistance in connection with lobbying or referenda activities, or voluntarily adopting a course of conduct so as to forestall legislation that would instead mandate such conduct.[339]

Case law also reflects the substantial amount of discretion that the profit objective provides managers. Judgments rarely, for example, disturb a decision for which some plausible profit-oriented justification is given.[340] Even charitable contributions have been permitted.[341] The profit objective does not serve as a single, objective, easily monitored goal, but as a justification for managers to do essentially what they please. The "hidden

339. T.D. 2 § 2.01, *supra* note 330, at 28-29.

340. *E.g.*, Kelly v. Bell, 266 A.2d 878 (Del. 1970); Shlensky v. Wrigley, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968); Union Pac. R.R. v. Trustees, Inc., 8 Utah 2d 101, 329 P.2d 398 (1958).

341. *E.g.* Union Pac. R.R. v. Trustees, Inc., 8 Utah 2d 101, 329 P.2d 398 (1958); *Sorensen v. Chicago, B. & Q. Ry.*, 112 Neb. 248, 199 N.W. 534 (1924).

agenda"[342] of those defending the profit objective is perhaps to maintain this state of affairs.

Supporters of the profit objective have criticized the corporate social responsibility proponents for the "insuperable problem of defining what the public interest is, and when the pursuit of profit maximization should be sacrificed for these ends."[343] Implicit in this position is the notion that it is known what the profit maximizing course of action is which must then be sacrificed. As previously explained, profit maximization does not produce a readily identifiable goal or course of action. Efficiency theorists also assume that a corporation can operate only on the basis of a single replacement goal. Indeed, some of those who have adopted the efficiency model have gone so far as to suggest that a corporation will self-destruct if it pursues inconsistent goals.[344] Of course, that is not the case when the power model's conceptual lens is used. The corporation pursues numerous and often inconsistent goals which enable the corporation to adapt to its social, political, and economic environment. The social responsibility debate loses contact with reality when it becomes involved with the abstraction of a single end or objective for the corporation. The important focus must be instead on the procedures for making decisions on behalf of the corporation[345] and on the identity of decision-makers.

The importance of the identity of those making decisions (which in turn affects the goals that the public corporation will pursue) becomes apparent when the breadth of the corporate decision-maker's discretion is made explicit. The Delaware Supreme Court in a recent decision, for example, stated that the "board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders."[346] This is not a restatement of the law, but it makes explicit that which has been, to a large extent, implicit in the law and obscured somewhat by the fiction of the profit objective. Even the recently enacted Pennsylvania statutory provision (that directors may consider the effects of their decisions "upon employees, upon suppliers and customers of the

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342. Note the play on the words used by Professor Fischel in *The Corporate Governance Movement*, *supra* note 14, at 1284.

343. *Id.* at 1268-69.

344. Easterbrook & Fischel, *supra* note 139, at 405.

345. The corporate law has recently become more serious about reviewing procedures for decision making. *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

346. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985)).

corporation and upon communities in which offices or other establishments of the corporation are located"[347]) is not a large departure from what is currently permitted, given the substantial deference granted by courts to the substantive decisions of corporate decision-makers.[348] These developments, however, bring to the fore basic issues of whether directors are appropriately selected and qualified to make such decisions. These issues have been obscured by the fiction of the profit goal, which is held out as the single objective and easily monitored goal with respect to which managers have special expertise.

B. *Election of the Board of Directors by Shareholders*

A primary principle of corporate law is that shareholders shall select and thereby determine the qualifications of directors.[349] Various reform proposals have been made over the years to modify this principle by specifying certain qualifications for directors such as independence and/or by providing for the selection of directors by other constituencies or a governmental agency.[350] To some extent, these proposals are motivated by recognition of the substantial discretion managers have in making corporate decisions and the desire to make the corporation more accountable, responsive, or sensitive to a wide variety of constituencies and concerns. Among these proposals are ones that advocate that the board of directors should consist of outside directors, "public interest" directors, "professional" directors, or constituency directors, including employee directors.[351]

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347. PA. CONS. STAT. ANN. § 8363b (Purdon Supp. 1988); *see also* OHIO REV. CODE ANN. § 1701.59(E) (Anderson Supp. 1987)

> A director, in determining what he reasonably believes to be in the best interests of the corporation, shall consider the interests of the corporation's shareholders and, in his discretion, may consider any of the following: (1) The interests of the corporation's employees, suppliers, creditors, and customers; (2) The economy of the state and nation; (3) Community and societal considerations; (4) The long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation.

Id.

348. *See supra* notes 340-41 and accompanying text. *cf.* Conard, *supra* note 211, at 1476-83.

349. *See supra* note 46.

350. *See infra* note 351.

351. *E.g.*, R. DAHL, *supra* note 295, at 121-29 (favoring election of employee directors); R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION 124-28 (1976) (proposing a shareholder-elected board to be comprised wholly of full-time, outside board members, each of whom will be given separate oversight responsibilities); C.

Reform proposals of this kind are criticized on a number of grounds. First, the proposals contain "arbitrary" features. How should the percentage of outside or constituency directors be determined? What constituencies should be represented, and how should they be selected?[352] Second, public interest and constituency directors would "politicize" the board[353] and, therefore, interfere with efficient decision making. Third, the stakes of these directors in the company are inadequate to ensure efficient decision making,[354] particularly the stakes of outside and public interest directors. Fourth, the expertise of outside, public interest, and constituency directors is insufficient for membership on the board.[355] Fifth, market processes will be distorted if constituency representatives become board members.[356] Sixth, constituency directors will have conflicts of interest.[357] This is particularly serious because the directors have interests that are inconsistent with general corporate welfare.[358] Seventh, there are more efficient means for other constituencies to interface with the company. For example, employees can engage in collective bargaining.[359] Eighth, minority representation on the board by outside or constituency directors is unhelpful, because they may be "frozen out" of decision making or be ineffective for other reasons.[360]

These criticisms, to a large extent, come from the utilization of the efficiency model. According to this model, compositions

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STONE, WHERE THE LAW ENDS 152-83 (1975) (proposing that, for each $1 billion of assets or sales, whichever is higher, ten percent of a company's directors be public interest directors, appointed by a Federal Corporations Commission or the SEC and approved by a majority of the other board members); Moscow, *The Independent Director*, 28 BUS. LAW. 9, 12-15 (1972) (advocating that an "independent" director be assigned by governmental agency to corporations whose securities are registered under § 12 of the Securities Exchange Act of 1934).

352. *E.g.*, E. HERMAN, CORPORATE CONTROL, CORPORATE POWER 283 (1981); O. WILLIAMSON, *supra* note 58, at 309.

353. *E.g.*, E. HERMAN, *supra* note 352, at 284; O. WILLIAMSON, *supra* note 58, at 310-11.

354. *E.g.*, Easterbrook & Fischel, *supra* note 139, at 403-06; Fischel, *The Corporate Governance Movement*, *supra* note 14, at 1282-83. Reference is also made to the discussion of asset specificity, *see supra* text accompanying notes 174-227.

355. *E.g.*, M. EISENBERG, *supra* note 7, at 22-23; Fischel, *The Corporate Governance Movement*, *supra* note 14, at 1282-83.

356. *See e.g.*, Goldschmid, *The Greening of the Board Room: Reflections in Corporate Responsibility*, 10 COLUM. J. L. & SOC. PROB. 17, 26 (1973); *see* O. WILLIAMSON, *supra* note 58, at 311-12.

357. *E.g.*, M. EISENBERG, *supra* note 7, at 22-23; *see supra* note 212 and accompanying text.

358. *E.g.*, M. EISENBERG, *supra* note 7, at 22-23.

359. *E.g.*, M. EISENBERG, *supra* note 7, at 20-21, 23-24, 161. *See generally* O. WILLIAMSON, *supra* note 58, at 298-325.

360. *E.g.*, E. HERMAN, CORPORATE CONTROL, CORPORATE POWER, *supra* note 352 at 290-91.

and functions of boards should be left to the marketplace, which has opted for the present system. All other means of determining compositions and functions are "arbitrary" and thus not valid. Due to the operation of market forces, board membership will be determined on the basis of efficiency considerations. The evolution of board composition will assure that board members will have the necessary expertise, stake in the enterprise, similar or different qualifications or interests to ensure efficient decision making. Other interested constituencies will naturally interface with the corporation in ways which economize on transaction costs. Artificial arrangements imposed on the corporation will either be circumvented, be ineffective, or decrease the efficiency of the corporation. Although the corporate law which provides that shareholders shall elect directors can be viewed as governmental intrusion into the operation of the marketplace, this principle is defended as that which would be contracted for by the parties in the absence of transaction costs to protect shareholders' residual rights or asset-specific investments.

The power model provides a different conceptual lens for assessing these proposals. First, the power model demonstrates that the situation which now exists, with the board composed of shareholder representatives, is as "arbitrary" as the structures proposed, because it is not the result of inexorable market forces or explained adequately on the basis of efficiency considerations. It results from a mixture of social, cultural, and power factors. The selection of "monitoring" directors by chief executive officers is, in fact, considerably more "arbitrary" than would be selections based on legislative criteria or selections by third parties.

Second, the power coalition model shows that the corporation is already highly "politicized." While diversity would increase at the board level with public interest or constituency representation, this diversity does not necessarily interfere with efficient decision making. Of course, the question "efficient for whom?" is particularly relevant here. Such representation would make it more difficult for the internal coalitions to utilize various strategies to insulate themselves from the demands of various constituencies.[361] This representation would increase the corporation's sensitivity to other interests. If the ability of the company to respond rapidly to changing conditions is claimed to be the problem with diversity on the board, it is important to emphasize: (1) that the board serves primarily a monitoring, rather

361. *See supra* text accompanying notes 247-77.

than a decision-making, function; (2) the German experience with codetermination regarding responsiveness of German industry to technological change;[362] (3) that generally complex decisions involving the assessment of ambiguous or uncertain situations are best made by groups rather than by individuals;[363] and (4) that quick decisions do not necessarily translate into operating successes because acceptance of those decisions by others is important. The Japanese system of consensus decision-making, though slow, has been heralded as superior to the relatively fast CEO decision-making process in American enterprises.[364] More importantly, through broader representation it is likely that the resulting decisions will be acceptable to more groups.

Third, the power model indicates that one should be skeptical of the claim that outside and constituency directors do not have the necessary stake in the company, whereas inside directors and shareholders do. The power model demonstrates that membership on the board results not from the stake one has in the enterprise, but from power considerations. Even representation on the board resulting from resource dependence (informal cooptation) occurs as a result of the company's dependence on the resource and not as a result of the stake the constituency has in the firm.[365] Indeed, the problem with existing governance arrangements is that they do not give sufficient attention to the needs of those who depend on or have a stake in the company. Certainly, constituency representation on the board accomplishes this purpose. As for "public interest" directors, their stakes can be made to approximate those of current inside and outside directors by monetary and reputational benefits and sanctions.

Fourth, the power model demonstrates that one should be more suspicious of the merits of the expertise argument. The claim of expertise is a common means for attaining and maintaining power.[366] The validity of this argument depends upon the functions of the board. Because the board is not intended to manage the corporation,[367] but to monitor and sensitize the cor-

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362. *See supra* text accompanying notes 215-16.

363. D. HELLRIEGEL, J. SLOCUM, & R. WOODMAN, *supra* note 63, at 228-29.

364. *Cf.* W. LONG & K. SEO, MANAGEMENT IN JAPAN AND INDIA 64-65 (1977); Sours, *The Influence of Japanese Culture on the Japanese Management System*, in JAPANESE MANAGEMENT: CULTURAL AND ENVIRONMENTAL CONSIDERATIONS 31 (S. Lee & G. Schwendiman eds. 1982).

365. *See supra* text accompanying notes 228-316.

366. *See supra* text accompanying notes 313-14.

367. *E.g.*, M. EISENBERG, *supra* note 7, at 139-41.

poration to important issues, these functions are best served by outside and constituency directors.[368]

Fifth, market processes will not be "distorted" with constituency representation on the board. This can be demonstrated even by using the efficiency model's own concept of the firm. Under that model, the firm is a nexus of contracts or marketplace in which all constituencies, in essence, negotiate with one another through their agent, the managers. Constituency representation on the board permits more direct negotiations without the fiction of an agent. Market processes are not distorted, but are facilitated. A distortion results when the accurate sharing of information is hampered by the managers' monopoly over this information. The power model also questions what is meant by the "distortion" of the market because it is socially constructed.

Sixth, the claim that in certain circumstances the interests of constituencies may diverge from that of the corporation, ignores the fact that the corporation should exist only by virtue of the values that constituencies derive from its existence. The corporation should not be reified. The viability of a firm itself is not a virtue apart from an assessment of its various functions and effects. With respect to the competing interests of different groups, the law has devised ways to deal with conflict of interest situations involving corporate managers. This same law can be used with respect to constituency directors.[369]

Seventh, while there are other ways in which various constituencies interface with the board, such as collective bargaining for employees, the power model emphasizes the power implications of hierarchy. The board is situated ideally at the top of the corporation's hierarchy to assure that the corporation consider various interests.[370] Some union officials, however, oppose employee membership on the board for fear of being coopted.[371] Nevertheless, board membership could serve as an additional entree for labor rather than replacing collective bargaining.[372] For an in-

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368. *E.g.*, R. DAHL, *supra* note 295, at 133. The benefits of constituency representation may also justify educational costs.

369. *See supra* note 212 and accompanying text.

370. The author does not intend to overemphasize, however, the importance of boards or board membership in determining corporate behavior. *See* M. EISENBERG, *supra* note 7, at 141-48; H. MINTZBERG, *supra* note 19, at 76-81. Nevertheless, with different methods of selection and qualifications for board members, the board's effectiveness in determining corporate policies and sensitivities can be enhanced. *See* Summers, *supra* note 211, at 183-85; *see also* text accompanying *infra* notes 376-78.

371. This article makes the same claim for shareholders under existing legal rules. *E.g.*, Lipton, *supra* note 140, at 45 n. 199; Summers, *Industrial Democracy: America's Unfulfilled Promise*, 28 CLEV. ST. L. REV. 29, 47 (1979).

372. Summers, *supra* note 211, at 164-67.

creasing number of employees, board membership will provide the most significant means of access because collective bargaining is on the decline in the United States.[373] Also, as previously noted, participation at the board level can have the beneficial effect of increasing the life of participatory arrangements at lower levels in the organization.[374]

Eighth, minority board representatives can be "frozen out" by management from participation in decision making through such strategies as the formation of committees which do not include minority members and by decision making prior to board meetings. While the power model demonstrates that organizational process rules can enhance the power of certain individuals or groups, various procedures have been suggested which can lessen the probability that these strategies will work.[375] Moreover, it is important to note that while the control of the firm does not change with minority representatives on the board, the amount of total firm conflict and the "character of decisions" can change.[376] This situation has been found to be the case in countries that have codetermination or require employee membership on the board (often in a minority position). One writer observes "[a] system of consensus has emerged under which 'management . . . can risk conflict with the workers . . . only if these conflicts are factually and socially justified.' "[377] Professor Vagts notes the advantage of employee participation because it takes into account the human implications of decision making. He observes:

> An outsider is favorably impressed by the humanity and care with which new jobs have been found, or even created by bringing in new industries, and workers retained or pensioned . . . . [O]ne feels that through codetermination a process for handling such problems had been set up which made it possible for each side to

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373. *Id.* at 37, 42, 158.

374. *See supra* note 214 and accompanying text.

375. *E.g.*, Summers, *supra* note 211, at 176-77 (For example, minority representatives can be assured participation on committees and matters that may be delegated to committees and management currently can be limited.).

376. *Id.* at 183-84; Eisenberg, *supra* note 7, at 160.

377. Comment, *supra* note 210, at 985 (citing H. KATER, DAS MITBESTIMMUNGSGESPRACH Nos. 5-7 (1976)).

see the other's point of view and to cooperate in reducing pain to its minimum.[378]

It is not the purpose of this Article to advocate a particular governance structure.[379] The objective has been to demonstrate that the power model permits a different response from the efficiency model to these reform proposals concerning the composition and functions of the boards of directors.

A recent study of board compositions by Baysinger and Butler purports to show that board composition should be left to voluntary, evolutionary changes.[380] The subject of board composition and functions then should not be left without analyzing this study. Baysinger and Butler compared the board composition of 266 firms in 1970 and 1980. They found that the number of outside directors increased during this period,[381] despite the absence of a mandatory rule at the federal level. It is unlikely, however, that the addition of outside directors during the 1970s was natural or evolutionary in the sense used by Baysinger and Butler. During this period, there were substantial social and political pressures on companies to add outside directors.[382] In fact, the choice of 1980 as the comparison year was disingenuous, because that was the middle year of the Securities and Exchange Commission's Proxy Disclosure Monitoring Program (1979-81).[383] The SEC statistically monitored board compositions during this period, with the view of making regulatory changes if voluntary changes were not made.

Baysinger and Butler also concluded that the implementation of a proposal to place a majority of independent directors on the board may adversely affect shareholder welfare, because firms that achieved above-average financial performance did not have a majority of independent directors.[384] But neither did the be-

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378. Vagts, *Reforming the "Modern" Corporation: Perspectives From the German*, 80 HARV. L. REV. 23, 71-72 (1966); *see also*, E. JACOBS, S. ORWELL, P. PATERSON & F. WELTZ, *supra* note 215.

379. The Fifth Company Land Directive, for example, offers alternative systems of employee participation. *See* Murphy, *The Amended Proposal for a Fifth Company Directive—Nihil Novum*, 7 HOUS. J. INT'L L. 215 (1985); Welch, *The Fifth Draft Directive—A False Dawn?*, 8 EUR. L. REV. 83 (1983).

380. Baysinger & Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J. OF LAW, ECON. & ORGANIZATION 101 (1985).

381. *Id.* at 113-14.

382. Kripke, *The SEC, Corporate Governance, and the Real Issues*, 36 BUS. LAW. 173, 189-92 (1981).

383. *See supra* note 221.

384. Baysinger & Butler, *supra* note 380, at 119, 121.

low-average performers.[385] In fact, Baysinger and Butler found that firms with an above average percentage of independent directors in the early 1970's (although below a majority) enjoyed better records of relative financial performance in the latter part of the decade than firms with average or below average percentages.[386] This evidence can be used as easily to support the claims of the proponents of mandatory changes in board composition.

CONCLUSION

The efficiency and power models provide different perceptions of corporate behavior. The efficiency model views the corporation as mainly reactive with governance structures that are designed to deal efficiently with various constituencies. The corporation responds to concrete realities such as the residual rights held by shareholders or the asset-specific nature of shareholders' investments. Persons bargaining for their own protection and competition in various markets cause managers to efficiently deal with the demands of others. Using this model, basic principles of corporate law can be supported as they were by the traditional ownership/entrepreneurial models of the firm. Shareholders are properly represented on the board of directors, and managers should operate the corporation to benefit the shareholders alone.

In contrast, under the power model, the corporation actively seeks to structure its environment to serve its needs of autonomy and discretion. While certain concrete realities exist, such as the scarcity of resources, how these resources are used and distributed is a matter of social organization, dependent on cultural, historical, social, and power factors. The tools of the efficiency model, such as residual rights and asset-specificity, are shown to be rationalizations for existing power relationships. As previously demonstrated, arguments utilizing these features can likewise be used to support other governance structures such as employee membership on the board. Under the power model, shareholder membership on the board is understood as a cooptative device designed to legitimate the substantial amount of discretion held by managers to make value judgments. Under this model, principles of corporate law are highly suspect.

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385. *Id.* at 119.
386 *Id.* at 117.

The power model provides a more "open textured" response to corporate behavior and structure than the efficiency model, which seeks to justify existing power structures on the basis of pseudo-scientific principles of natural selection. Structures need to be examined with an understanding of power sources, power strategies, and the importance of social and cultural values. Beware, for "efficiency" has become the talisman of the power holders.

Not only do the efficiency and power models elucidate basic principles of corporate law, but they are useful in understanding recent developments in corporate law. The efficiency model's contract perception of the shareholder-management relationship provides the basis for state legislatures adopting various opt-out or opt-in provisions which permit shareholders to decide the law to be applied to each corporation. For instance, some states permit shareholders, through voting, to relieve directors of certain fiduciary duties owed shareholders.[387] These laws have been passed in response to the directors' and officers' insurance crisis spurred by the plethora of litigation concerning tender offers.[388] Under the efficiency model, this legislation is difficult to challenge—shareholders as parties to the contract with managers should be free to contract for different contractual terms. The power model, however, offers a different line of analysis. Fiduciary duties of directors may be understood as a response by the judiciary to shareholders' unequal bargaining position. If this is the case, the matter cannot be resolved through shareholder voting. Fiduciary duties may also serve a legitimating role. They may operate in fact or appearance to protect other segments of society from ill-considered corporate decisions. If so, they serve a broader purpose than the efficiency model suggests. Under the power model then, the fiduciary duties of directors become a matter for public policy determination rather than a decision to be made by shareholders on a company-by-company basis.

In conclusion, the conceptual lens that is used to view corporate behavior, whether adopted consciously or unconsciously, can lead to different judgments about who controls or should control the modern corporation, about the operation and effect of existing corporate law, and about the standards and principles that should govern corporate decision making. Conse-

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387. *E.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986).

388. Lee, *Limiting Corporate Directors' Liability: Delaware's Section 102(b)(7) and the Erosion of the Directors' Duty of Care*, 136 U. PA. L. REV. 239, 240-41 (1987); Note, *Statutory and Non-Statutory Responses to the Director and Officer Liability Insurance Crisis*, 63 IND. L.J. 181, 182 n.10 (1987).

quently, greater attention should be given to developing and understanding models used in assessing the corporate law.