

Testing the Normative Desirability of the Mediating Hierarchy

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I. INTRODUCTION

In this short Essay, I make two small contributions. First, I sketch a modest empirical project for testing the normative desirability of Blair & Stout's mediating hierarchy concept as a solution to the team production problem. Second, I argue that, depending on the results of that empirical project, it may be desirable to allow public corporations, as a matter of corporate law, to contract around the shareholder profit maximization norm.

In their influential article, *A Team Production Theory of Corporate Law*,¹ Professors Margaret Blair and Lynn Stout explained how corporate law might be viewed as an attempt at solving what is known as the team production problem.² At its core, this problem has to do with the opportunistic behavior that arises when multiple economic actors make investments—whether of labor, capital, or otherwise—in a business venture where these investments are said to be “firm specific” because they cannot be easily withdrawn and redeployed in other projects.³ The problem is how to construct a governance regime that will create incentives for the various team members to act optimally in light of these firm-specific investments.⁴ *Ex ante* governance tools, like compensation, lead to shirking, whereas *ex post* haggling over the surplus leads to inefficient rent-seeking.⁵

The solution that Blair and Stout focused on in their article is the independent third party who is given control over the firm and is in

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1. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

2. *See id.* at 249.

3. *See id.*

4. *See id.*

5. *Id.*

charge of allocating profits to the various members of the team commensurate with their individual and team efforts.⁶ Blair and Stout argue in their article that corporate law may be understood as creating such a “mediating hierarch” in the board of directors, at least with respect to public corporations, where board independence from corporate stakeholders is more likely because of the dispersed shareholder base.⁷ This theory has at least two obvious implications for corporate law as it applies to public corporations. The first is that a board of directors, particularly one that is independent from other stakeholders, should have decisionmaking authority. The second is that, in exercising this decisionmaking authority, the board should have the flexibility to take into account the interests of the various members of the team, not just the shareholders.

The value of any theory can be measured along both descriptive and normative dimensions. How does the mediating hierarch theory fare as a descriptive and normative matter? As a descriptive theory, the model produces mixed results. To be sure, the model does a good job of describing how the law allocates decisionmaking authority in the corporation. The theory says that one should expect the board to get this authority, and the law reflects that expectation.⁸ Of course, the mediating hierarch theory requires more than just authority located in the board. It also requires board independence. But boards of public corporations are largely independent as a result of stock exchange rules,⁹ although it is important to emphasize that this independence requirement makes the theory less applicable to private corporations that lack an independent board.¹⁰ Thus, at the very least, the theory appears to be a fairly accurate

6. *Id.* at 249–50.

7. *See id.* at 250–51.

8. *See* DEL. CODE ANN. tit. 8, § 141(a) (2014). This provision is also reflected in nearly every other state corporate code. *See* MODEL BUS. CORP. ACT ANN. § 8.01 cmt. (2002) (collecting statutes).

9. *See* N.Y. STOCK EXCH., INC., LISTED COMPANY MANUAL § 303A.01 (2009), available at http://www.nyse.com/lcm/lcm_section.html; NASDAQ LISTING RULE 5605(B)(1), available at <http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F1%5F4%5F3&manual=%2Fnasdaq%2Fmain%2Fnasdaq%2Fdequityrules%2F>. For a history of board independence, see generally Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007).

10. In a notable article, John Coates argues that the percentage of corporate boards that meet the preconditions of Blair & Stout’s mediating hierarch—most notably “independence” from other stakeholders—is vanishingly small in light of the lack of disinterested boards. *See* John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable are U.S. Corporations?*, 24 J. CORP. L. 837, 844 (1999). However, Professor Coates was writing before the independence reforms ushered in by the Sarbanes–Oxley Act, and so that domain of the mediating hierarch is probably much greater now than it used to be.

description of how corporate law allocates decisionmaking authority in the public corporation.

However, the theory is less successful in describing the criterion that public company boards are to use in exercising this decisionmaking authority. Blair & Stout's answer is that the board is to mediate among the interests of the various stakeholders who have made firm-specific investments.¹¹ This, after all, is the nature of the deal that these stakeholders struck in their solution to the team production problem. They agreed to relinquish control over firm assets to a mediating hierarchy, who would then allocate profits in an efficient manner, commensurate with the effort of the various input factors. The problem, however, is that corporate law generally does not reflect a stakeholder profit maximization norm. A brief perusal of Delaware court opinions reinforces the fact that a board's goal is to maximize shareholder profit, not that of any other stakeholder.¹²

To be sure, some argue that this shareholder profit maximization norm is irrelevant because it is effectively unenforced as a result of the business judgment rule.¹³ So, in a sense, the debate over the mediating hierarchy's success as a descriptive theory is really a debate about the power of unenforced norms.¹⁴

Without weighing into this debate at a more general level, my sense is that those who argue in the corporate context that the norm imposes a real constraint have the better of the argument. First, although the norm is not enforced by judicial intervention, it is operationalized through equity-based compensation, which probably has a greater incentive effect

11. See Blair & Stout, *supra* note 1, at 250–51.

12. See, e.g., eBay Domestic Holdings v. Newmark, 16 A.3d 1 (Del. Ch. 2010); Shlensky v. Wrigley, 237 N.E.2d. 776 (Ill. App. Ct. 1968); Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

13. See, e.g., Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005).

14. See, e.g., Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1269 (1999) (“Although legal standards of conduct are characteristically accompanied by liability rules or other enforcement regimes, even a legal standard of conduct that is unaccompanied by such a regime may be effective because of its impact on social norms. While social norms differ from legal rules, there is often a symbiotic relationship between legal rules and social norms. On the one hand, legal rules are often based on social norms. On the other hand, many legal rules have an expressive effect—that is, in addition to their regulatory effects, legal rules send messages of various kinds. Adoption of a legal rule that is based on a social norm sends a message that the community regards the norm as especially important. This message increases both the likelihood that the norm will be internalized and the reputational penalties for violating the norm. Furthermore, legal rules add, to the force of a specific obligational norm, the force of the general norm of obedience to law, which is one of the most powerful norms of our society.”).

than the threat of judicial review anyway.¹⁵ Second, the shareholder profit maximization norm is subject to constant reinforcement, particularly in public companies, when boards hire lawyers to advise them as to their duties. Norms are not particularly meaningful if there is no mechanism for transmitting the norms to the relevant community of actors. However, the corporate law norms created by the Delaware courts have a very efficient and effective mechanism of transmission: the members of the corporate bars of New York and Delaware.¹⁶ Third, the market for corporate control does a good job of restricting boards to focusing on maximizing shareholder value.¹⁷ Finally, it appears that as an empirical matter, boards are complying with the shareholder profit maximization norm, regardless of whether the norm is subject to judicial enforcement. One of the dominant narratives of the recent financial crisis is that bank executives took excessive risks because they focused too much on maximizing shareholder profits.¹⁸ Whether it is because of the structure of compensation, norm reinforcement, or the fear of a hostile takeover, executives of public corporations appear to focus on maximizing shareholder profit.

For all of these reasons, I think it is fair to say that the shareholder profit maximization norm is not simply a toothless norm in U.S. corporate law, but is one that affects actual corporate behavior. Consequently, it seems that the mediating hierarch theory is not particularly successful as a descriptive theory. It gets the question about the means of corporate law—the “who decides” question—right. But its response to the question about the ends of corporate law—the “how do they decide” question—is almost certainly incorrect.

Nevertheless, Blair & Stout’s mediating hierarch may still be valuable as a normative theory. It seems likely that at least some firms may find the optimal solution to the team production problem to be an independent board, combined with a firm-wide or stakeholder profit maximization norm. Indeed, this seems likely to be the case where there are sig-

15. Equity-based compensation was originally adopted as a way of tying the performance of corporate executives to shareholder profits. *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

16. *See, e.g.*, Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1106 (1997) (“There is evidence that some of the most important and dramatic [corporate law norms] are transmitted fairly directly, while others are mediated by corporate lawyers who digest them, transmitting the lessons through the exercise of judgment and through the ways in which they structure the board’s deliberations.”).

17. *See, e.g.*, Coates, *supra* note 10, at 849–50.

18. *See, e.g.*, Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers’ Pay*, 98 GEO. L.J. 247 (2010); Lucian A. Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008*, 27 YALE J. ON REG. 257 (2010).

nificant trade-offs among stakeholders, for example, in the banking context.

II. THE TEST

How might one test the normative desirability of Blair & Stout's solution for the team production problem? One approach would be to consider how often private parties select this particular governance package—an independent board combined with a firm-wide profit maximization norm—when forming an entity. The problem of course is that Delaware law does not allow corporations to contract around the profit maximization norm. It does, however, grant LLCs this flexibility.¹⁹ Thus, one way of assessing the normative desirability of Blair & Stout's mediating hierarchy solution would be to consider the frequency with which promoters of public LLCs select this particular governance package.²⁰

This type of project would offer some insight into the normative desirability of the board as a mediating hierarchy. If promoters are selecting this governance package only rarely, then that might suggest that Blair & Stout's solution for the team production problem is not as desirable as other alternatives in the real world. If, by contrast, promoters are selecting the mediating hierarchy governance package quite often, then that might suggest that Blair & Stout's solution has some real-world purchase.

To be sure, this research question poses some interpretive difficulties. Just because public LLCs might eliminate fiduciary duties does not, in and of itself, mean that they have adopted a mediating hierarchy approach to the team production problem. They could simply be exploiting inefficiencies in the market for business entity law in order to engage in self-dealing without the risk of liability.²¹ However, this self-dealing in-

19. It is more commonly stated that Delaware allows promoters to modify or eliminate fiduciary duties altogether in the LLC context. But, to the extent that the profit maximization norm emanates from these duties, particularly the duty of care, the modification or elimination of the duties have the same effect on the norm. In other words, LLC promoters effectively have the ability to modify or eliminate the shareholder profit maximization norm as well. *See, e.g.,* Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 557 (2012).

20. In a review of Larry Ribstein's book on "uncorporations," Grant Hayden and Matthew Bodie have argued that the rise of LLCs should spur a reconsideration of corporate theory. *See* Grant M. Hayden & Matthew T. Bodie, *The Uncorporation and the Unraveling of the "Nexus of Contracts" Theory*, 109 MICH. L. REV. 1127 (2011). This research question might be viewed in this vein, even if it is probably not exactly what Hayden and Bodie had in mind.

21. *Cf.* K.A.D. Camara, *Shareholder Voting and the Bundling Problem in Corporate Law*, 2004 WIS. L. REV. 1425, 1427 n.8 (2004) (identifying various arguments suggesting sources for such inefficiencies in the market for corporate law).

terpretation might be less likely if the LLC agreements reflect an attempt to police self-dealing transactions while at the same time allowing directors and management the flexibility to take into account the interests of stakeholders as a whole.

For example, Mohsen Manesh has found that roughly half of all public LLCs and LPs eliminate fiduciary duties altogether with respect to their boards of directors.²² Does that mean that these entities have effectively contracted for a mediating hierarch approach to firm governance? Not necessarily. That depends on whether the underlying contracts reflect an attempt to reign in self-dealing and other aspects covered by traditional fiduciary duties while allowing the board to take into account stakeholder interests. A clearer example of a mediating hierarch governance package would be an LLC that retains traditional fiduciary duties but explicitly adopts a stakeholder profit maximization norm.²³

The policy payoff of answering this type of research question could be significant. After all, if stakeholders are choosing this mediating hierarch governance package in the LLC context, maybe that implies that stakeholders should have the ability to make the same choice in the corporate context.

III. POTENTIAL POLICY IMPLICATIONS

In other words, if stakeholders appear to favor the mediating hierarch governance package in the LLC context, perhaps this implies that the shareholder profit maximization norm should not be a mandatory rule but rather a default rule for corporations. One would think that this might be a common policy proposal, given the contractarian approach to corporate law that is dominant in the literature. Contractarianism tends to favor default rules in corporate law, so one would naturally think that it would favor the same approach with respect to the criterion that boards should apply in exercising their decisionmaking authority. But, surprisingly, most contractarians tend to argue against a default approach to the shareholder profit maximization norm.²⁴ Thus, a proposal to make that norm a default rule would be nontrivial. Evidence that private actors in an analogous context contract around shareholder profit maximization with some

22. See Manesh, *supra* note 19.

23. See, e.g., *In re Atlas Energy Resources, LLC*, 2010 Del. Ch. LEXIS 216, at *34–35 (Del. Ch. Oct. 28, 2010).

24. See, e.g., FRANK EASTERBROOK & DANIEL FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 35–39; Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2002); Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629 (2002).

regularity, as a solution to the team production model, would go some way in supporting this policy prescription.

What about the objections to such a policy prescription? One of the more vocal contractarians, Professor Bainbridge, argues in favor of a mandatory shareholder profit maximization norm on the basis that, among other things, nonshareholder constituencies do not make firm-specific investments,²⁵ although this claim seems demonstrably false,²⁶ as Bainbridge later seems to concede.²⁷ Bainbridge further argues that shareholders are not as successful as other stakeholders at obtaining contractual protections, although it is not entirely clear that this claim is true either.²⁸ One of the more provocative arguments that Bainbridge makes is that allowing boards to take into account interests other than those of shareholders might lead to “board misconduct.”²⁹ It is difficult to know what to make of this argument, however, for Bainbridge is typically so deferential to the board that he is opposed to almost any constraint on the board’s autonomy.³⁰ And yet, it appears that in Bainbridge’s model, this deference is warranted only when the board is considering what is best for shareholders. However, when the board is considering what is best for the firm as a whole, extreme mistrust of board action is the order of the day.³¹

It is not entirely clear what might account for these almost diametrically opposed positions. One suggestion that Bainbridge makes is that shareholders lack the political clout that other stakeholders, like labor, might enjoy, with the implication being that a stakeholder profit maximization norm would simply allow for this skewed political influence to assert itself.³² However, it is not clear (to me, at least) that this is true as an empirical matter. Even if it is empirically accurate, it is not clear to me that this is a sufficient justification for opposing a stakeholder profit maximization norm. The answer to that question depends on a compari-

25. See Bainbridge, *supra* note 25, at 587.

26. And in fact, most contractarians do not make this argument. See, e.g., EASTERBROOK & FISCHER, *supra* note 25, at 35–39 (noting that other corporate stakeholders make firm-specific investments, while defending shareholder wealth maximization on the grounds that nonshareholder groups can protect themselves adequately through contract); Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 188–92 (1989) (same).

27. See Bainbridge, *supra* note 25, at 587.

28. See *id.* at 588.

29. See *id.* at 581–84.

30. See generally Stephen M. Bainbridge, *Response to Increasing Shareholder Power: Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006).

31. See Bainbridge, *supra* note 25, at 581.

32. See *id.* at 590.

son of the profits associated with the efficient projects that the board might forgo under a stakeholder—versus a shareholder—profit maximization norm, taking into account the rent-seeking costs associated with increased political lobbying. That question, however, seems much too complicated to dismiss with Bainbridge’s political lobbying argument.

But just because Bainbridge’s arguments against allowing for a stakeholder profit maximization norm are not ultimately persuasive, that does not by any means settle the matter. Indeed, the strongest objection to making corporate law’s maximand a default rule is that it already more or less is because of the existence of LLCs and benefit corporations.

However, this objection also does not appear particularly forceful upon further investigation. It is true that entrepreneurs could adopt a mediating hierarch solution to the team production problem through the LLC entity form. The problem, however, is that the corporation is still favored by a significant margin over the LLC for a publicly traded firm because of a combination of custom and tax reasons. In other words, the investing public is unfamiliar with the LLC form, and the tax administrative costs of a publicly traded entity subject to partnership tax treatment are extremely high.³³ Furthermore, the relatively few LLCs that are publicly traded are probably least in need of the mediating hierarch structure because they are mostly investment firms, where shareholder wealth maximization makes more sense anyway because of the absence of significant stakeholder trade-offs. For these reasons, it is not particularly satisfying to argue that the LLC can simply serve as the vehicle for creating a mediating hierarchy to solve the team production problem.

Nor is the benefit corporation a particularly promising vehicle for realizing the potential benefits of the mediating hierarch approach to corporation law. The businesses choosing benefit corporation status are those engaging in social enterprise, which typically has some purpose in addition to generating profit.³⁴ Consider, however, those businesses that wish to maximize long-term firm value without a particular social mission but that do not believe that a shareholder wealth maximization norm is the way to do it. The benefit corporation does not seem to be the best alternative for those types of businesses.

33. See, e.g., Heather M. Field, *Checking In On “Check-The-Box”*, 42 LOY. L.A. L. REV. 451, 519 (2009).

34. See, e.g., Dana Brakman Reiser, *Theorizing Forms for Social Enterprise*, 62 EMORY L.J. 681 (2013) (citing as examples of social enterprises companies that hire low-income or foreign-born individuals and companies that donate products to the poor).

IV. CONCLUSION

For these reasons, there may still be value in making the corporate law maximand a default rule, assuming of course that we think that the mediating hierarch solution to the team production problem is normatively desirable. In this short Essay, I have suggested one way that we might examine that empirical question—through an analysis of the governance packages chosen by public LLCs. There might be other methods of addressing the same question. The broader point is that this is a question worth examining, and the reason it deserves such examination is because of Blair & Stout's excellent work. Few indicators of scholarly impact are more compelling than that.