Surplus, Agency Theory and the Hobbesian Corporation

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ABSTRACT

The agency perspective has allowed us to understand a remarkable range of phenomena. It is the dominant theory for the study of corporations. The theory, however, in its current state of development, is limited in its explanatory power. It is capable of describing incentive provision, but it is incapable of addressing the allocation of value between the various parties to an enterprise.

As presently conceived, the main tenants of agency theory, chiefly being the self-interest of rational, self-maximizing actors, lead one to view the distribution of value as a result of ceaseless negotiation and conflict. This endless conflict is not however consistent with observation, which highlights a difficulty with the theory. In this essay, we will use both the agency analysis and also governance theory, so as to present a fuller, modified, conception of the corporation which resolves this difficulty.

The resolution to what would otherwise seem this unending "war of all against all" comes through governance and authority. The achievements of organizational goals require individuals to forfeit their autonomy and accept the stylized roles and duties proscribed to them by a governing party, so that the organization may function coherently. In this extension of agency theory, governance theory acts as an important and necessary complement to the current structured incentives perspective of agency theory, and the corporation, by deciding and fixing the allocation of value.

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INTRODUCTION

Agency theory will always be relevant to the discussion of the corporation or any other business entity. The fundamental question, however, is not the theory's viability, but its core relevance to an explanation of the corporation and corporate law. The theory, nonetheless, as currently understood and developed, is limited in its viability. It takes as its axioms details that are far from self-evident and are in need of further exposition. In this Essay, we will present a fuller picture of the firm and agency theory than is currently offered. Namely, we view the actual distribution of value between the parties to an enterprise as incapable of clear and objective determination, by markets or otherwise. Rather, the tenants of agency theory, chiefly being the self-interest of rational, self-maximizing actors, lead one to view this problem as the particularized outcome of ceaseless negotiations. We offer a resolution to what otherwise seems an unending war of all against all, by positing the non-egoistic concern of the enterprise's individuals for the organization's purpose. The achievement of organizational goals requires individuals to forfeit their autonomy

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and accept the stylized roles and duties proscribed to them by an outside party so that the organization may function coherently.[1]

In its present conception, we view agency theory's explanatory capability for corporate action and incentive not as all-inclusive, but rather encompassing only a subset of a broader and more fundamental analysis of the essence of the corporation. Agency theory can at times be perceived as being dominated by the technicians and financial economists who study, structure, and design compensation so to align incentives.[2] The lucidity of this

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1. Our subsidiary conclusion, that of a third-party authority being necessary to governance, is in general accord with the views of not only our argument's forbearer, Thomas Hobbes, but also with those of Margaret M. Blair and Lynn A. Stout, as well as Stephen M. Bainbridge. *See generally* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999). Our reasons for drawing this conclusion are nonetheless distinct. That we have reached this subsidiary point in common, and that, in addition, our arguments have turned on some common points as well, is surely encouraging. Our place of divergence lies after this point of advance, with the final conclusion concerning the appropriate ends of corporate governance.

As to the ends, the authority or discretion of the governing third party, which we posit as necessary to coherent organization, must be given some purpose, or decision-criteria, according to which it can express itself. Blair and Stout propose that this "mediating hierarch" should "balance team members' competing interests." Blair & Stout, *supra* at 281. Alone, this phrase lacks meaning and provides no actual guidance without further specification; equality, perhaps, is what is meant, or some other tuning mechanism, analogous to that system of principles where a large object might "balance" a smaller object at the other end of a seesaw of certain proportions, may be intended. With a slight refinement, they argue that this "balance" should keep "everyone happy enough that the productive coalition stays together," *id.*; but should one ever be happier than "enough?" Where should the repository of unspent happiness reside? They hit closer to the mark when they suggest that the role of this third party is to protect the corporate coalition—thereby identifying an ideal of harmony with a corporate will-to-exist as the proper purpose. *Id.* at 283. This proposition is more correct. We would argue, as will become apparent in this essay, that the corporation's existence tomorrow depends on surplus tomorrow, and more surplus means only more surety of this favorable outcome—grow the pie! This and "protection of the corporate coalition" are to us nearly synonymous with "shareholder wealth maximization," contra stakeholder-ism, given the nature of the market (as derived from consumer preference).

2. We here refer to the standard agency theory conceptualization from finance literature. *See generally* Stephen A. Ross, The Economic Theory of Agency: The Principal's Problem, 63 AM. ECON. REV. 134 (1973) (an early formalization of the principal-agent problem); Bengt Holmstrom, *Moral Hazard and Observability*, 10 BELL J. ECON. 74 (1979) (examining a formulation for efficient contracting between principal and agent based on various assumptions about the agency relationship);. The value of compensation is assumed to be equal to an agent's participation constraint, or opportunity cost, which is set by markets. *See id.* Our modification would be: compensation is equivalent to the participation constraint *and* surplus. The amount of surplus is *not* set by markets. If our view is correct, the amount of surplus is determined such that

analysis, with its principals, agents, and markets, and its apparent objectivity, obscures a fundamental truth. Conflicting interests require not just structured incentives, but also, in the end, a determination of how value is distributed. For all of the *method* that agency-technicians are able to apply, they cannot answer the question of who gets what, or precisely how much—although they can well answer how.[3] There is a constant battle between the constituencies who form the enterprise over the appropriate distribution of value. A better explanation of the corporation encompasses this realization. We suggest a potential resolution to this conflict in the form of broad-based equity ownership among the internal corporate constituencies.

I. THE AUTHORS ASSUME INDIVIDUAL RATIONALITY

It is reasonable, first, to assume the rationality of all of the "individuals" involved in our analysis. By this we mean simply that an individual behaves purposefully and takes action tending towards the maximal satisfaction of some goal. An individual may, of course, value many things and pursue many goals, some in conflict with each other. For ease of exposition, however, we will assume that individuals generally value financial gain and seek only to maximize their earnings over the duration of their lifetimes. When we say that individuals act so as to maximize "earnings," we may just as easily say (*salva congruitate*) that individuals act to maximize their "happiness," "utility," or store of "tiddlywinks."

Individuals will at all times prefer more income to less income. While the future is uncertain—individuals are unable to foresee every eventuality of their present actions and unable to imagine every possible state of the world that may occur by virtue of chance or nature's changing course—individuals are nonetheless able to form rough expectations and adjust those expectations in response to new stimuli and information. Individuals will act in a rational manner, in accordance with their preference for more lifetime earnings, such that at any instance we may suppose the reason for which one course of action is chosen rather than another is that the individual expects to earn more in the chosen course of action than in the alternative.[4]

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the entity's ultimate purpose (whether it is shareholder value maximization or not) is furthered. This determination can give coherence to the firm.

3. *See, e.g.*, Alex Edmans et al., *A Multiplicative Model of Optimal CEO Incentives in Market Equilibrium*, 22 REV. FIN. STUD. 481 (2009) (reflecting an admirable and characteristic example of such efforts).

4. "S: Is there anyone who wants to be wretched and unhappy?
M: I don't think so, Socrates.
S: Then no one wants bad things, Meno, if indeed he does not want to be like that."

Plato, *Meno*, *in* A PLATO READER: EIGHT ESSENTIAL DIALOGUES 60, 69 (C.D.C. Reeve ed., 2012).

II. OPPORTUNITY COST AND SURPLUS

Individuals have, at all times, a set of alternative potential courses of action. For instance, individuals who are currently employed may, under leave of their current employer, continue with the present position or submit a letter of resignation this very instant and enter the open labor market or start a business of their own instead, or they may concurrently seek open positions and interview with other employers while continuing in their current employment.

It should be stressed that the individual is never compelled to choose one alternative over another. One always chooses between options voluntarily. Even where a contract specifies penalties to the individual pursuing or not pursuing some course of action, the individual may choose at his or her discretion between the alternatives and bear what contractual costs are associated with either decision.

The individual formulates ordered preferences for each option in the set of alternatives.[5] Assume, for example, that one faces a choice between option A, option B, and option C, where the associated value of the expected earnings to each is equal to A, B, and C dollars respectively. More being always preferable to less, if A > B > C, then the individual will prefer option A to B, option B to C, and option A to C. Behaving rationally, the individual will choose option A over options B or C when presented with the choice. The second-best option, B, is the opportunity cost to choosing A. In other words, by choosing option A, the individual gives up B dollars in expected future earnings that were available by the pursuit of option B. The rational individual will choose option A and earn an amount A, which can be decomposed into the sum of B, *opportunity cost*, and the difference between A and B, which is called *surplus*. In order that a chosen action is consistent with our conception of rationality, the amount of surplus must be positively valued, or else equal to zero in the special case of indifference.

Where rational commitments of labor and capital to economic ventures are concerned, the expected earnings for any individual who works or invests purposefully in such a manner are equal to the opportunity cost of the commitment plus some additional measure of surplus.

III A SIMPLE EXTENSION: JOINT RATIONALITY

Many of the options available to an individual will be cooperative ventures that involve other individuals. If such an alternative is ultimately pursued, our analysis must assume the rationality of all parties to that joint venture. Therefore, for each individual party involved, the value received from the joint venture

5. Kenneth J. Arrow, *Utilities, Attitudes, Choices: A Review Note*, 26 ECONOMETRICA 1, 1–2 (1958).

must exceed the opportunity cost of whatever is given up in consideration for the agreement. The individual payout from a joint venture, or enterprise, is again equal to the sum of surplus and opportunity cost for each party. The total value of the joint venture, excluding externalities, is therefore equal to the sum of opportunity costs over all participants and an additional positive amount of *enterprise surplus*, which can provide the requisite individual surplus to each member. The value of the whole is, in this sense, always greater than its constituent parts.[6]

For example, consider an entrepreneur's choice to enter into a contract with a bookkeeper or, conversely, the bookkeeper's choice to enter into a contract with the entrepreneur. By hiring the bookkeeper, the entrepreneur can spend more of his or her time on sales and product development and earn an additional $1,000 per annum. On the other hand, the bookkeeper has interviewed for many positions and received an offer of $500 per annum, and does not expect to receive any greater offers. If no other suitable individuals apply for the bookkeeping position, it is clear that a mutually rational contract is feasible and the two individuals will form a joint venture. The entrepreneur will pay the bookkeeper his or her opportunity cost, $500, plus an amount of the bookkeeper's surplus. The entrepreneur will earn his or her outside opportunity—in this case, the value of not hiring a bookkeeper (or, alternatively, the value of hiring a different bookkeeper)—plus some amount of the entrepreneur's surplus. In this case, the enterprise surplus is $500 ($1,000-$500) and will, in due course, be divided between the entrepreneur and the bookkeeper.

All contracts require, as a condition to their existence, some modicum of enterprise surplus to support the mutual rationality of the parties to the contract.[7] The particular value, of course, can range from nearly zero to an infinite amount at the polar limits—and will, in practice, fall at some intermediate point.

IV. THE FIRM AS A NEXUS-OF-CONTRACTS

When two individuals bind themselves to each other through contract (implicitly or explicitly), they form a simple firm or organization. When a multitude of contracts are formed between

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6. *See* Armen A. Alchian & Susan Woodward, *The Firm is Dead; Long Live The Firm: A Review of Oliver E. Williamson's* The Economic Institutions of Capitalism, 26 J. ECON. LITERATURE 65, 70 (1988) ("The classic, paradigmatic private property firm is a coalition among owners of separately owned resources whose value as a team exceeds the sum of the market values each could get separately.").

7. Surplus need not be derived from the value of final consumption. It may instead relate only to the preferences of the producers. Mutual gain may be had through trade amongst them alone. If a job requires two tasks, which each prefers in opposite, the parties may gain through division of labor, between themselves.

larger numbers of participants, a more complex organization is formed. Sometimes, the individuals involved will petition their sovereign[8] to form a contract providing for the embodiment of a legal fiction that is to be endowed with certain qualities, rights, privileges, and obligations before the law and society. In such a case, the organization of individuals may become a corporation, a partnership, a sole proprietorship, or any other legally sanctioned body. In many instances, this legal body may then enter into contracts with other either corporeal or legal bodies and thus form the structural core of the *nexus-of-contracts* that comprises the firm or organization.[9]

No matter the degree of complexity, however, the original assumption of mutual rationality of all of the parties involved still holds. Each individual chooses his or her association with each other and with the legal body, in the same manner laid out before, voluntarily. Individuals do so because the choice of mixing their capital or labor with this enterprise offers them some individual surplus in excess of their opportunity cost.

What is necessary for our entrepreneur-bookkeeper firm is also necessary for the largest multinational conglomerate; any firm's existence depends upon the existence of enterprise surplus that can then provide individual surplus to each member and, in that manner, bind the firm together through only the independent, rational action of its participants.

Investors will only buy a share of stock if they expect more return from the dollar invested with the company than from a dollar that could be invested elsewhere. A bank will provide a loan if the assurances it receives and the likelihood of a return convinces the bank that the loan is more profitable than another that could be made. Assembly-line workers will show up to work on Monday if they expect to earn more doing so than could be earned elsewhere. Customers will buy a product if they expect more satisfaction from the company's product than from another. The executive will sign an employment contract if he or she believes that doing so is better than seeking employment elsewhere. Board members will accept their duties if the compensation, the return on active oversight of the investment, and the honor and distinction resulting from the position prove to be the best use of their time and talents.

If the enterprise surplus does not first exist, there is no value to offer all of the various other enterprise-constituents and therefore there can be no enterprise to speak of. But, if the enterprise surplus does exist, we will see that the firm should also exist, almost by necessity.

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8. Please see The Honorable Jeffrey W. Bullock, Delaware Secretary of State, 820 N. French Street, 5th floor, Wilmington, DE 19801.

9. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 313 (1976).

V. NICHE AS THE SOURCE OF SURPLUS

Conventional economic analysis tells us that this surplus should not exist for long. In perfect competition, earnings over opportunity cost are discovered by others and driven to zero by an active pricing mechanism. Here, our firm should hardly seem a cohesive organization; a thin film of surplus—in theory, infinitely small—is all that would support a transaction. Exogenous, unanticipated changes to prices would force renegotiations or dissolve the transaction as alternative opportunities become more or less attractive. The corporation as we know it would not exist if markets were to function perfectly and completely in this idealized zero-rent world.[10] All production would, to the contrary, occur in one-off, transient open market transactions among independent, disloyal parties. Our "firms" would exist only for the passing duration of a particular transaction.

In this perfectly responsive market model, even one competing interest to a transaction will result in a bidding contest that will consequently eliminate rents or surplus. The firm or corporation then must exist in the spheres of economic coordination where the market, or the set of alternatives, is not. (In a sense, this being where the opportunity set is discontinuous.) The market being only the members of the set of alternative uses of resources for final consumption, the firm must, therefore, exist by virtue of its uniqueness or distinction, in some shape or form.[11] If the firm was not capable of something that it alone could accomplish, price adjustments would eliminate the surplus. The ultimate source of surplus is niche. (Total surplus is derived from niche and scale.[12])

One must think of the economy and the entrepreneur in the following manner. Various resources exist in time and place. They exist as an Arcadian, disordered set without prejudice to human preference in their original manifestations and locations. Intermixed with the material resources are individuals, who seek to order the world around their preferences—it thusly progresses from Arcadia to an economic Utopia. These individuals, in addition to contributing their labor and talents positively to the set, consume from it; they consume in accordance with their wants and material desires. All economic activity issues forth from these consumptive wants and desires. We would not dig coal out of the earth if nobody

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10. R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 386 (1937).

11. MICHAEL E. PORTER, COMPETITIVE ADVANTAGE: CREATING AND SUSTAINING SUPERIOR PERFORMANCE 11, 17 (1985).

12. The prior analysis and some of the following commentary were originally suggested to us by several remarks made by Richard D. Parsons during a lecture he gave to graduate students at the Wharton School of the University of Pennsylvania. *See* Richard D. Parsons, Lecture at the Wharton School of the University of Pennsylvania: Decision Making in the Leadership Chair (Feb. 20, 2013). His insights on scale and niche in the context of organizational strategy were particularly useful. *See id.*

wanted it; we would not grow crops if they were not desired by individuals in need of food; scholars would not produce writings and teachings if these were not, somehow, desirable activities to either themselves or to others. In the end, an activity that was not aimed at the satisfaction of some desire would belong somewhere other than the sphere of economic activity. The entrepreneur exists both within and outside this environment.

There is an old tale about an economist who does not pick up a $100 bill because, in efficient economies, $100 bills do not lay haphazardly on the ground.[13] The efficient economy is an idealized world, where every resource is put to its most valuable use in relation to consumer desires. Here, any action or change of course would be futile and could only lead to a less efficient world because it necessarily involves moving an object from the penultimate state of its greatest usefulness. This is not, of course, the world we live in. As mentioned, in relation to human needs, we inherit a chaotic, disordered, unprejudiced set of assets. Moreover, many of those useful objects exist in places as yet undiscovered by us and may be put to use in combinations that are also as yet unknown.[14]

Facing this environment, the entrepreneur's concern is primarily that of inquiry. He or she is to reconnoiter this environment, using inference and accepting uncertain expectations, to find where the constituent resource distribution may be better arranged so as to map more efficiently onto final consumptive desires. Upon finding an unsatisfactory situation, the entrepreneur makes it more satisfactory, affecting a transformation through mutual adjustment of each asset involved. Each asset then, both physical and human, is moved or freed to more productive uses. The difference between the sum total of consumptive value before the entrepreneur's action and the sum total after is where our enterprise surplus is derived. By a constant process of discovery across space and time, of fresh and unexploited niche, and through this transformation, we move progressively from our disordered world towards an ideal, maximally efficient world, that which the economists imagine. This is a process that is unlikely to be completed any time soon. In the meantime, there is ignorance, disorder, and *entrepreneurs*, which collectively give rise to surplus and firms.

VI. ON SCALE AS THE MULTIPLIER OF NICHE

The entrepreneur first must identify this market niche. A niche can take many forms. Some entrepreneurial discoveries will be local

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13. *See* Steven M. Davidoff, *Unusual Moves in Confronting Apple's Mountain of Cash*, N.Y. TIMES, Feb. 12, 2013, at B7.

14. *See generally* Friedrich A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945) (discussing the centrality of knowledge to economic activity).

in nature—for example, that a number of people must go out of their way for coffee in the morning and a new shop could better serve them. Some entrepreneurial innovation may be global in nature—for instance, the discovery that people everywhere would be better served by the ability to make their own coffee at home. Each type of innovation draws resources away from their original uses.

When entrepreneurial ideas are potentially broad in their applicability, a business will expand, drawing resources away from whichever local economy the business comes to inhabit. Whatever discovery provided the germ of its existence is applied elsewhere. A niche is given scale. As the company expands, with each stage enabled by expectations of individual surplus, the total amount of enterprise surplus grows with it.

Around the initial niche, the firm develops a core competency and streamlines its processes further. This core is the information and systems—specific to the company itself—which allow it to better serve, and continue to improve upon its ability to serve, its particular niche than others without it could do. Each innovation therewith creates value by moving and freeing resources in time and place to more productive uses.

An expansion could be affected in many ways. For instance, one could imagine a firm whose core competency was nested with the entrepreneur and perhaps several other managers. In this case, surplus would be derived from their particular knowledge and expertise. Surplus is given scale by the managers' ability to delegate tasks to a relatively larger number of subordinates. This effectively allows increasing specialization by the entrepreneur, who is free to devote considerably more of his or her time to the niche activities. The manner in which the company specializes may affect the ultimate distribution. One could expect some companies, for instance, to have distinct sectors of employment. In the primary sector, specialized employees may develop the methods of exploiting the firm's particular niche. Secondarily, many necessary tasks may be routinized and delegated to less essential personnel. The secondary employees may be more interchangeable with other market alternative workers and therefore blend towards the market in the firm-market duality. The sources of surplus may be distributed more towards the primary, specialized employees than to the secondary and thus bind them more closely with the firm (meaning there is a greater buffer of surplus to prevent separations that occur when their opportunity cost changes so as to then exceed the value of continuing the relationship).

VII. THE PROBLEM OF AGENCY, OR AGENCY COSTS?

The problem of agency is merely embedded within this overlying contractual structure. Contracts, involving more than one party, each with independent purposes, will involve conflicting interests *eo ipso*. Where one may prefer rest and comfort, the other surely might

prefer that person's fulsome efforts; where one may prefer safe and tidy investments, the other may desire extravagantly risky projects and capital allocations; where one may prefer to travel expensively while on business, the other might wish more modest accommodations; and while a buyer may desire a product of the highest quality tendered for the lowest price, a seller would be happiest if it were of the lowest quality and sold for the highest price. Each inherently concerns the question of distribution. An employee taking leave to rest on the job gains leisure and recreation while the employer loses the value of ardent labor. Although all contracts will involve an agency problem, of this most general characterization, there is a set of policy solutions that can be implemented in response. There may be an effective remedy available in this set—one that can minimize the costs of agency such that there still remains some surplus and thus reason for the contract to be formed—or there may not be. For instance, costly systems of monitoring or methods of incentive alignment that involve costly risk shifting can be required in response to the independence of interests. If the value to be gained from the enterprise, facilitated by a like alignment of interests, exceeds these costs, one may still expect a firm.[15] But, in this analysis, agency costs are just that—costs; no different than materials costs, transportation costs, or production costs. One does not say "the problem of materials costs," likewise the "problem of agency," is really just an agency cost. A second-order analysis of all the costs, including those of agency and then of expected revenues, is needed to determine the feasibility of a contract and thereby understand the foundation and essence of the firm. Agency problems are only a subspecies of a more general economic question.

VIII. THE DENOMINATIONS OF AGENCY ACTIONS

An action taken can (1) increase the total value of the firm as a whole (i.e., produce enterprise surplus, where all costs have been considered) or (2) reduce or leave unchanged the total value. In the first case, it is clear that the action will be taken and all parties stand to benefit from the expansion in value. By virtue of the expansion, each party could be given a suitable inducement to cooperate. By contrast, in the next instance of contraction or no change in surplus, an action is taken at the expense of another party.

It is clear, given our earlier discussion, that actions of the first sort are necessary first to a firm's existence and later to its

15. *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 780 (1972) ("If there is a net increase in productivity available by team production, net of the metering cost associated with disciplining the team, then team production will be relied upon rather than a multitude of bilateral exchange of separable individual outputs.").

expansion. Each decision then invariably results in some distribution of the resulting surplus going to either of the parties. Over time, these divisions can ossify into a more or less characteristic firm-level distribution of enterprise surplus.

Actions of the second sort are where agency problems fall. They break the distributional stasis so as to allow one party to gain, at the expense of other parties. The action will be taken, as we previously argued, if it is of benefit to the party choosing it; if the net effects of the action are nil, then what was beneficial to one party must be of equal harm to some other parties. One may also conclude that these actions in some sense always follow actions of the first, mutually beneficial type. When dealing with surplus, the initial distribution may be considered arbitrary, only one among an innumerable set of feasible possibilities that will all be considered advantageous to, and therefore will be accepted by, all the parties involved. One may say that with any action of the first, surplus-increasing type, the distribution has an arbitrary starting point (or does not exist) and then, only by actions of the second, neutral or harmful type, the distribution is negotiated and finally realized. Under this conception of the firm and agency theory, perhaps terminology derived from political models is most informative; advantages are gained through "bargaining, negotiation, and coalitions."[16]

Alas, we have arrived at a general definition of the problem of agency. The problem of agency is concerned with the redistributive actions. From the perspective of any particular party, an agency cost is incurred when another party gains at the first party's expense. With a view to the entire corporation, agency costs are incurred when costly actions are taken, either ex ante or ex post, which are intended to effect the distribution.

So, is agency theory still viable? We hope to have established by arguing from self-evident axioms that it is not only viable, but necessary. Organization in a firm requires some distribution of enterprise surplus, a process which will bring agents and principals into conflict. All actions will then involve a distributive component. Distribution implies agency concerns.

Agency theory errs in its specification of "reservation wages" that are set by markets. Such terminology imbues a false sense of objectivity to the distributional issue. In light of our discussion of surplus, this view cannot be sustained.

IX. MUTUAL DEPENDENCY: PRINCIPLE-AGENT OR AGENT-AGENT?

Our definition does not require a sharp distinction between agents and principals. While the principal-agent relationship is generally thought of as the archetypical case of a taskmaster

16. Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57, 63 (1989).

principal dictating his demands to the servile agent, the distinction is usually not so clear. Both principal and agent must enjoy some measure of surplus by virtue of their mutual cooperation and are therefore in some sense bound to each other. A failure to maintain the relationship is bad for both parties; therefore, the authority within may not be unambiguously apportioned. A "mutual dependency" is in many cases closer to an accurate characterization of the situation than is principal-agent.[17] This, however, would appear to leave an intractable situation that is only reconciled tenuously through delicate negotiations, societal norms, and other forces of personality. There is at heart a ceaseless tension and struggle between conflicting interests.

For example, although the relationship between a board and management is often seen starkly through the principal-agent framework, one could benefit conceptually by softening this view. It is true that a board possesses the authority to fire management, but it is likewise true that management has the authority to quit if they so desire.[18] For a board, losing a management team will most likely result in tremendous disruption, loss of critical management-specific institutional knowledge, and, ultimately, lower performance. There is a significant amount of "surplus" that the company receives from its relationship with a particular management team rather than with another. The converse is also true; management has usually invested a significant amount of their careers, training, and skill set in the enterprise, and may be unlikely to find similar employment elsewhere. They likewise receive surplus from continuing the relationship with the board. Both management and the board thus have wide latitude in their potential dealings with each other, and the lines of authority cannot be drawn in a concrete fashion.[19] But,

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17. *See, e.g.*, Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 240 (1979) ("In as much as the value of this capital in other uses is, by definition, much smaller than the specialized use for which it has been intended, the supplier is effectively "locked into" the transaction to a significant degree. This is symmetrical, moreover, in that the buyer cannot turn to alternative sources of supply and obtain the item on favorable terms").

18. The Prophet Sirach's wisdom concerning household management is instructive for agency theorists. Although a slave must not be treated too kindly—"[f]odder, a wand, and burdens, are for the ass; and bread, correction, and work, for a servant. . . . Set him to work, as is fit for him: if he be not obedient, put on more heavy fetters"—one has paid for him and must limit one's severity, for if the slave should run away, "which way whilt thou go to seek him?" *Sirach* 33:24, 28, 31 (New Oxford Annotated Bible: New Revised Standard Version, with the Apocrypha).

19. *See* Alchian & Demsetz, *supra* note 15, at 777 ("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 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. I can "punish" you only by withholding future business or by seeking redress in the courts for any

there is always the potential that one side may preempt the other, gain control, and take hold of a greater portion, or nearly the entire amount, of the surplus. (And, for the other parties, the opposite will be received.) From this possibility, each, even at rest, must possess a guarding tension and watchfulness.

This analysis suggests a decentralized allocation of power throughout the organization. What is true of management regarding their firm-specific earnings and investments may be said in varying degrees about all of the other employees. As such, mutual dependencies and negotiation are essential or important components to all of the enterprise's relationships. But, often this exigent dynamic is suppressed by the centralized power given to managers who then decide, on the basis of general policies, the particular outcomes of these negotiations. In other words, the firm's general policy may be to pay an individual a certain amount of compensation for performing a certain job. So as to maintain the integrity of this general policy, and so as not to set an adverse precedent, individuals are sometimes given limited ability to contradict it by bargaining for an alternative amount. In effect, an employee is offered a take-it-or-leave-it proposition. If the "it" offers surplus, the employee will take "it."

X. THE DESIRABILITY AND POTENTIALITY OF ENDING THIS WARFARE OF INTERESTS

The firm, as we have described it, is in a constant state of conflict. It is comprised of a multiplicity of interests, engaged in a war of all against all. The will and interests of one to the other are locked in opposition. It is only under strain that a successful project can be completed and each can gain. There is, to every transaction that extends over time, a constant threat of expropriation—of one party gaining at the expense of his or her counterparty.

This can present a great difficulty for the firm because the firm's entire existence is predicated upon its distinctness from market alternatives. That which supports a transaction by producing the surplus must be unique. The development of unique assets requires specific investments by participants. Specific investments become sunk costs whose values are dependent upon the relationship for which they are made. The difficulty that arises is then that of inducing participants to make such investments under the threat of later expropriation by the other parties.[20]

Consider the bargaining and negotiation of surplus as though it were a game of chess. If the play were free, it would not be difficult

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failure to honor our exchange agreement. That is exactly all that any employer can do.").

20. *See generally* Williamson *supra* note 17, at 234, 238, 241–42, 250–54 (discussing transaction-specific investments, opportunism, the impossibility of complete contracting, and the responses to gaps in contracting, which provide critical insights for our reasoning herein).

to find two willing parties for a match. Suppose, however, there was a requirement that before each move, a player must pay $5 into a pot that will be given to the winner. One may decide to play at the outset if the opponents were equally matched. But, it becomes less likely that one will give over the fee for continuing play if the other opponent were a much stronger player or if, in later stages of the game, the opponent had gained a clear advantage in strategy or points. The likelihood that all the gains would go to the other, stronger player results in depriving the match of what may be otherwise desirable play.

Therefore, where unbridled self-interest reigns supreme, the ability and incentive to initiate costly, but nonetheless potentially profitable ventures are diminished. The guarded and suspicious atmosphere of a Hobbesian business entity can therefore be counterproductive and undesirable:

> In such a condition there is no place for industry, because the fruit thereof is uncertain, and consequently, not culture of the earth, no navigation nor use of commodities that may be imported by sea, no commodious building, no instruments of moving and removing such things as require much force, no knowledge of the face of the earth; no account of time, no arts, no letters, no society . . . .[21]

This state of internal competition and strife is undesirable. One would expect that parties take measures to avoid such a situation or that companies that did not do so would be disfavored by the competitive evolution of the marketplace. This last is an important point. The company must fortify itself against not just discord within, but also discord without. In a competitive economy, its efforts to sustain its value are often thwarted by the strength of other rival communities (companies). Internal discord would then beget external weakness.

The parties to an enterprise may attempt to put an end to the perpetual conflict of their opposed and warring interests. To do this, they may specify through contract the payoffs and distribution to various state-contingent relational outcomes ex ante. In this, although each party's power to achieve beneficial terms is expressed in the negotiated contract, parties give up, for the duration of the contract, the ability later to express their particular interests, so far as the terms of the agreement specify the outcome and restrict free action. Before the contract was formed, particular outcomes and payoffs depended upon the free play of opposing interests. Afterward, the willed self-interest of the opposing parties is supplanted, insofar as explicitly expressed, by the terms to the agreement. Therefore, it can be seen that, through mutual

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21. THOMAS HOBBES, LEVIATHAN: OR THE MATTERS, FORM AND POWER OF A COMMONWEALTH, ECCLESIASTICAL AND CIVIL 81 (George Routledge & Sons Ltd., 1907) (1651).

covenant, the agent's power is transferred to the contract and given then to whichever authority enforces contractual terms. In a negotiated outcome, power refers to an agent's ability to exert and satisfy his or her will. The will being directed towards self-interest, an agent's power is the ability to achieve terms that accrue to the benefit of the agent's interests. In this sense then, when one cedes his or her will to a contract, one's self-interest is subrogated to the contract and becomes the interest of the contract, or of those who enforce it. Where a contract specifies a precise outcome, the ultimate authority over the matter is transferred to the courts, to the extent that they are able to enforce the term, and is not held by the individual parties to the contract. (This, of course, is subject to the costs involved in bringing the contract to court.) Through contract then, the agents may find recourse to quit the exploitive opposition of their *future* selves and endeavor cooperative ventures with less fear of the free expression of each other's interests.

To the extent that agency theory solves the problem of agency through contract design (i.e., compensation agreements), this is what is meant. With incentive contracts, higher payoffs result from states that are more favorable to the other party. Individual will is then subjugated to the contract and directed towards these specific ends.

In a world of perfect and costless information, all of the parties involved may specify precisely the terms of an agreement and the contingent payoffs resulting from all potential states of the world. This express ex ante distribution of surplus would also allow, given perfect information, perfect monitoring and legal enforcement of each tedious detail of the contracted terms. Through perfect contracting, the problems of expropriation can be avoided. In reality, however, a large proportion of the contract is left unwritten and cannot (or is too costly to) be written. (This is whence general fiduciary duties are derived.) As a result, much activity and negotiation result from ex post gap filling of unspecified contractual terms.

Because of the impossibility of complete contracting and enforcement, the parties to a contractual agreement must then return to the perpetual conflict of their warring interests as regards this gap-filling necessity.[22] This, in turn, deadens the incentives for making unique, firm-specific investments, while also promoting a suspicious, fearsome, cautious atmosphere.

The parties to an enterprise may again, however, attempt to put an end to the perpetual conflict of their opposed and warring

22. *See* Williamson *supra* note 17, at 242 ("joined as they are in an idiosyncratic condition of bilateral monopoly, both buyer and seller are strategically situated to bargain over the disposition of any incremental gain whenever a proposal to adapt is made by the other party. Although both have a long-term interest in effecting adaptations of a joint profit-maximizing kind, each also has an interest in appropriating as much of the gain as he can on each occasion to adapt.")

interests. To do so, by mutual covenant, they can, theoretically, appoint a third party who stands above the fray and is empowered to fill the contractual gaps at any and all future dates. This neutral, nonpartisan, impersonal arbitrator would be empowered by each party's original powers so as to thereby fill the contractual gaps itself. In this sense, and in the same manner as done through contract, each individual's self-interested will is transferred to, and becomes that of, the arbitrator (or, for instance, of "the corporation"). So long as this body, entity, form, principle, person or persons—in other words, the *central authority*—is sufficiently empowered and stands outside of the conflict, and all parties are alike in awe of its authority, then, to the parties who form the enterprise, the ultimate distribution of surplus and value becomes rather a consequence of necessity than of freely interested will. Something external to the conflict is indeed necessary to its resolution. We cannot even determine what one has right to or should have without an external standard of *right* or *should*. Order, peace between the interests, and a distribution of surplus may be provided for by this so-created authority. It becomes the final arbitrator of residual interests.[23]

To balance, proscribe, and preempt individual self-interests, the central authority enacts its chosen form of corporate justice, where roles, custom, compensation, positions, and status are, to various extents, determined impersonally and absolutely. Individual members of the enterprise would then become bound by the body that they have thus empowered in the instance of giving up their own self-interest. The individual participants within this firm would be forced to accept, as by necessity, the dictates of this ultimate decision maker. The choice to them becomes participation by the terms presented, or not to participate at all.

XI. STYLING THE FIRM

Where residual control rights and ultimate authority are abrogated by the individuals, the enterprise can then be styled so as to possess some essential unity of purpose or coherent wholeness in design. The atomistic quality of the perpetual warfare over surplus among the firm's participants can be transformed into a harmony of plenary interest. What for? For what purpose is the distribution of surplus determined? For what purpose are the roles of enterprise participants determined? For what reason is an individual paid amount x and not amount y? The answers to these questions help us to see the role of this central decision maker in styling the firm towards its essential unity of purpose. One may answer that the firm is styled, designed, and given form by the decisions of the central authority *so as to* maximize value for shareholders; so as to maximize value for all of the enterprise participants taken together; so as to benefit its customers; so as to maintain the integrity of the

23. *See supra* note 1 and accompanying text.

markets in which it operates; or so as to achieve any other objective. In this respect, regardless of the particular purpose chosen, the firm is given a teleological design through a central decision-making body that rationalizes its otherwise atomistic organization.

Among some firms, the individuals could develop an *amor fati* towards this chosen purpose. What is necessitated of themselves, required in the name of the specific objective, as articulated by that central authority, is not wished any different because it cannot be, and because the decisions of that body are seen not as adversarial, arbitrary, or self-interested. The body is viewed as one intending to affect a purpose that is worthwhile to achieve and for which decisions are made. It is in this state that a sacrifice or additional burden is gladly carried by an individual member of the organization, although it may affect the distribution of surplus, possibly to his or her detriment, *because* it is required of one in a particular position in a larger enterprise whose interests are of a greater sum than one's own. By accepting required duties, individuals aid in the achievement of that which can only be achieved in concert with others. Through their participation, they can be part of and gain satisfaction from that which is unattainable through an individual's own will alone. The communication and implementation of this design are essential elements of leadership (whether by CEOs, boards, or any other).

When one speaks of a successful sports team, for instance, one is apt to allude to this concept of *amor fati* being derived from the greater purpose of the whole. It is often said that each player on a successful team fills a role. This player may fill a subordinate role to others, but this role is given significance as a necessary part of a coherent whole. It is determined by the coach who is given the power to affect the ultimate design of the team so as to achieve some good. Again, it is by the same art and principle that an orchestra's effect is achieved outside of any individual contributor's efforts. Alone, the woodwinds, brass, percussion, or strings cannot produce the characteristic effect. The individuals must perform in concert. Necessary too, is the allocation of authority to principal players and conductors.[24]

Therefore, individuals choose their association with an enterprise because it is their best available option; they accept the terms given by the enterprise because they are necessary and because their interests become also those of the enterprise. In this manner, small, individual units of power or ability are aggregated into the larger unit of corporate strength or capability.

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24. *See* Raghuram G. Rajan & Luigi Zingales, *The Governance of the New Enterprise*, *in* CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES 201, 201 (Vives ed., 2000) (discussing an analogous example involving a movie cast and movie director).

XII. AUTHORITY AND ACCOUNTABILITY

Of course, for a company, the all-benevolent, meditating authority does not exist. Authority must be nested in the hands of individuals, who bring their own self-interest to the enterprise. There is, therefore, a danger that the teleological purpose of the ordered enterprise is in the end only that of the enrichment or aggrandizement of the particular holder of the authority. We would witness a descent back to the primitive, Hobbesian state of affairs with which we hoped to escape—only now with the addition of new players. As protection against this potential, one ultimately must again rely upon legal rules and the enforcement capabilities of our courts. Where there is decision-making authority granted to a board of directors, corporation law significantly qualifies it. The directors have absolute authority *except that* they cannot reappoint themselves (rule: the election of a director is dependent upon the affirmative vote of a majority of the shareholders in the annual meeting[25]); they cannot flagrantly disregard the interests of the entire class of shareholders (rule: the corporation should be run so as to maximize long-term shareholder value); they cannot refuse to call a meeting (rule: the internal procedures denoted in articles and bylaws must be adhered to); and so on. In this respect, authority, which is necessary to coherent organization, finds its counterbalance in accountability through rules that are ultimately enforced by courts.[26]

Additionally, through the duty of loyalty, corporate law seeks to repress this potential for self-enrichment inherent in the necessary vesting of authority in the officers and directors within the corporation. It attempts, through this rule, to create disinterested fiduciaries that can therefore style and organize the firm for the benefit of its stockholders and the whole without regard for their own particular private interests. By demanding the unselfish loyalty of those in whom authority must be vested, the law severs the myriad avenues for self-enrichment upon which personal impulses may otherwise flourish.

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has

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25. MODEL BUS. CORP. ACT. § 7.01(a) (2007) (requiring an annual shareholders meeting); § 7.28(a) (discussing voting for directors at the annual meeting); *cf.* James B. Stewart, *When Shareholder Democracy is Sham Democracy*, N.Y. TIMES (Apr. 12, 2013), http://www.nytimes.com/2013/04/13/business/sham-shareholder-democracy.html?pagewanted=all&_r=0.

26. This, of course, allows for the complementary influence of other factors as well, such as reputation, culture and the standards of professionalism.

> established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty . . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.[27]

By minimizing one's personal connections to the enterprise and interest in the decisions being made, the law calls upon directors and officers to act from benevolent inspiration. It demands that their intent not be to enrich themselves personally, but rather to act in accordance with the general interest. Therefore, through the application of statutory rules and the imposition of such legal duties, the irrevocable conflict between authority and accountability is mitigated, and self-interested tyranny (authority's progeny) is guarded against.

Additionally, corporate directors are prohibited, by the duty of loyalty, from using corporate office to pursue their own self-interest to the disadvantage of the corporation and its shareholders. In this respect, recognizing that the purpose of the corporation is shareholder value creation, the responsibility of these fiduciaries is to neutrally promote the corporation's interest rather than their own self-interests. This maxim helps ensure the organization's *efficiency*, whereby every decision, which concerns the individual and the particular, should ideally be made with only the consideration of utility to the whole. Only the directors' actions that benefit the corporation and *all* of its shareholders are permitted—though corporate actions that benefit the directors as merely fellow investors are allowed, provided there are no disproportionate wealth transfers to them by the corporation. So through the application of statutory rules and legal duties, the conflict between authority and accountability is mitigated. Authority, necessary to coherent organization on the one hand, is tempered by these prophylactic measures. The interconnected systems of power, authority, and accountability are what we define as governance.

XIII. A SUGGESTION CONCERNING LEGITIMACY, COORDINATION AND LEADERSHIP

While we, and agency theory, have described the business enterprise as a combination of selfish, self-serving interests, a corporation only functions effectively by virtue of a selfless communion of its members with its purposes and objectives. For most modern public corporations, that purpose is, legally, the creation of shareholder value. It is argued that this is fitting,

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27. Stephen Bainbridge, *Can Corporate Directors Take Third Party Pay From Hedge Funds?* PROFESSORBAINBRIDGE.COM (Apr. 8, 2013, 9:51 PM), http://www.professorbainbridge.com/professorbainbridgecom/2013/04/can-corporate- directors-take-third-party-pay-from-hedge-funds.html (quoting Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. Ch. 1939)).

appropriate, and desirable because through this focus, the livelihoods and happiness of all who participate in such a shareholder-oriented economy, in general, are also greatly improved.

Broad equity ownership has long been used as an incentive device to align the interests of all of the enterprise's members towards the goal of shareholder value creation. But, viewed solely as a tool for proper incentive provision, this could never be the ultimate solution to the inherent problem of cooperative and joint ventures. Regardless of the manner in which compensation is structured, it has *some* value. Again, if one party is to gain, it is at the other's expense. Therefore, even with this balm, there is the unavoidable problem of final allocation.

But, broad-based ownership is still, often, a good idea. Economic theory suggests a litany of potential problems and inefficiencies related to such a plan, ranging from the costs of poor diversification to its being a poor, indirect measure of task performance. And, we suggested earlier that equity incentives, while possibly creating value, nonetheless fail to affect the division of value. To argue that broad-based ownership has the potential to "solve" the agency dilemma would therefore appear to present a clear contradiction. When viewed from the perspective that there is an organizational imperative to "quit" one's self-interests, however, the benefits to broad equity ownership become apparent.[28] A key function of leadership is not only to define an organization's strategy and objectives, but then also, critically, to communicate them throughout. Through this communication, one enables individuals to understand their proscribed roles within the enterprise. This is ultimately how organizations are able to operate in concert and coherently. Where the purpose of an enterprise is to benefit an anonymous, amorphous class of shareholders, it can be difficult for leaders to communicate the importance of achieving this goal throughout the organization. (We speak here to managers and directors.) All leaders elicit support and loyalty by speaking in exalted phrases—"This product will change the world!" or "Next generation!" or "Green and Global!"—and equity ownership may provide a meaningful rhetorical tool, and a more receptive audience, for those whose goal is, in the end, simple *maximization of shareholder value*. It may just develop that famous *amor fati* of the well-cohered organizational *unit*.

While we may never end the war of competing interests—certainly this is true in the normal course of human events—we may at least find a way to make the subordination of one's own particular interests more palpable and appealing so that they may tolerably serve as secondary to the general interest. Having achieved this,

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28. *See* Alchian & Demsetz, *supra* note 15, at 790–91 ("If one could enhance a common interest in nonshirking in the guise of a team loyalty or team spirit, the team would be more efficient… The difficulty, of course, is to create economically that team spirit and loyalty. It can be preached…").

the competition over surplus may be muted. By creating a commonality of interest among the warring parties, we may soften the warfare that, as we argued, defines the modern corporation.

The law has attempted to resolve the problem of conflicting interests through the broad imposition of fiduciary duties on the agents, most notably upon directors and managers, the violation of which results in some form of legal liability to the principal.[29] The ineffectiveness of this remedy, however, later led to the drive for equity ownership by the agents as the most effective means to create a more shareholder-responsive agency.[30] Personal wealth alignment between the agents and principals through a commonality of interest created by equity ownership has been the favored path for addressing the hitherto "irreconcilable conflict."[31] But, the benefit is not purely a matter of proper provision of incentives. Rather, there is an element of gain by the resultant identification with the general good of shareholder value.[32]

In the never-ending competition for surplus, such widespread shareholdings can create a true commonality of interest for the constituent parties. Here, the point of ownership is not solely to provide individual incentive, as the agency-theoretic view would contend. It acts to promote and strengthen the willingness of agents to make the sacrifices that their duty demands because of a personal identification with the goal of shareholder value accretion.[33] It can lead to a focused culture to which all adhere—a culture of ownership.[34] In such a milieu, the incidents of malfeasance and misfeasance may be expected to decline, as vigilance and enthusiasm are maintained throughout the organization.[35] So too, frictions and conflicts resulting from the whims and caprice of individual interests will be expected to decline—to the

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29. *See* Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 651 (1995) [hereinafter Elson, *The Duty of Care*]; *see also* Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 148 (1996); Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 977 (1993).

30. *See* Elson, *The Duty of Care*, *supra* note 27 ("The solution to the problem of the passive board lies not in using the threat of legal liability . . . but in creating an environment where a board finds it in its own self-interest to engage in active oversight.").

31. *See, e.g.*, *id.* at 652 ("To ensure that [the board] will examine a management proposal in the best interests of the stockholders, we must make them stockholders as well.").

32. *See id.*

33. *See, e.g.*, *id.* at 653.

34. *Id.* (discussing this concept as "an alignment of the directors' interests with those of the shareholders").

35. *See id.* at 691. In a sense, the effect that will be achieved is a decentralization of Messrs. Alchian's and Demsetz's metering problem. It relates to their discussion concerning the possibility to "enhance a common interest in nonshirking." *See* Alchian & Demsetz, *supra* note 15, at 790.

organization's ultimate betterment, success, and the creation of long-term shareholder value.[36]

In the now-iconic book *The Capitalist Manifesto*,[37] Louis Kelso and Mortimer Adler call for broad-based employee stock ownership as one way to create a more vibrant capitalist system.[38] The idea, advocated for decades by Kelso, became the basis for the Employee Stock Ownership Plans, or "ESOPs" as they have become commonly known.[39] Originally, the idea was to create a greater bridge between labor and management through shared ownership goals.[40] To this end, it was suggested that a financial structure be created within a company to hold company stock for the benefit of company employees.[41] In 1976, the tax code was amended to create a preference for the establishment of such plans.[42] Unfortunately, the idea never achieved the widespread acceptance that Kelso had envisioned. By the mid-1980s, such plans became a highly valued anti-takeover device that placed stock not in employee hands for incentive purposes, but gave managerial "trustees" voting control over a large amount of company stock so as to make it more difficult for a hostile acquirer to gain control of the enterprise.[43] Broad-based equity ownership—rather than creating a unification of interest between labor and capital to create greater ultimate economic value—had degenerated in the ESOP form to become simply a method to enhance managerial capture of the enterprise. Despite this turn of events, we believe that the theory still has much promise for appropriate corporate function.

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36. *See id.*

37. LOUIS O. KELSO & MORTIMER J. ADLER, THE CAPITALIST MANIFESTO (1958).

38. *Id.* at 169–70

39. *Important Dates*, KELSO INST., http://www.kelsoinstitute.org/important-dates.html (last visited July 30, 2013) (listing 1956 as the year in which Louis Kelso invents the ESOP leveraged buyout).

40. *See* Steve Mariotti, *Louis Kelso, A Financing Revolutionary—Bringing Ownership to Workers Through Employee Stock Ownership Plans*, HUFFINGTON POST (Apr. 30, 2013, 12:44 PM), http://www.huffingtonpost.com/steve-mariotti/louis-kelso-a-financing-r_b_3186133.html.

41. *Id.* ("The process of an ESOP is it [sic] that a worker without capital gets stock and becomes an owner. Legally there becomes a pool of stock that is held in a separate corporation which is available to the worker when he or she leaves the company.").

42. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (including specific provisions regarding ESOPs).

43. *See* Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749, 1797 (1990) (explaining an ESOP and its use as a "defensive tactic for management in an attempted corporate takeover"); *see also* E. Richard Brownlee, Jr. & Robert F. Bruner, *The Leveraged ESOP as a Takeover Defense: The Case of Polaroid Corporation*, 1 J. M & A ANALYSIS 3, 4 (1990) (discussing the ESOP concept through one specific illustration involving Polaroid's use of an ESOP to avoid hostile takeover from Shamrock Holding).

In this vein, the National Association of Corporate Directors ("NACD"), a nonprofit organization established to meet the needs of individuals serving on corporate boards, convened a commission to study more-effective ways of preventing corporate fraud.[44] In 1998, that commission published a report entitled *Coping with Fraud and Other Illegal Activity*.[45] In this report, the Commission concluded that:

> The most effective way to prevent fraud and other illegal acts from taking place within a public corporation is not through the enactment of rigid codes of director and employee conduct, but rather through the creation of an organizational culture that aligns standards of high ethical behavior with self interest.
>
> Broad-based equity ownership throughout the organization by management, directors, and employees can create such an alignment. . . . If managers, directors, and employees all personally believe that their own wealth creation is directly tied to the organization's ultimate success, this may well be the most effective motivation for continuous vigilance throughout the organization.[46]

While the NACD commission intended such broad-based ownership as a means to prevent corporate fraud, we believe that this approach has another important appeal. As we have argued, through widely distributed equity, the company can cultivate a rich, strengthened unity of purpose throughout its varied and diverse forms.

CONCLUSION

Like political systems, conflict may explain the corporation better than simple agency. Agency theory as presently formulated, however, does not afford us the means to quit the conflict that cooperative ventures *should* entail. In order that we may achieve the coherent organized entity, we require more than agency theory's recommendations. For this, we need systems of governance. And, with such systems, we also need systems of accountability. Corporate law is the embodiment of these principles. Broad equity may be the appropriate tool to achieve the necessary commitment to such a system by the corporation's constituents.

At the heart of the business enterprise is fundamental conflict. Although it may be muted somewhat in the ways we have discussed,

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44. *See generally* NACD BEST PRACTICE COUNCIL & NAT'L ASS'N OF CORPORATE DIRS. (U.S.), REPORT OF THE NACD BEST PRACTICE COUNCIL: COPING WITH FRAUD AND OTHER ILLEGAL ACTIVITY: A GUIDE FOR DIRECTORS, CEOS, AND SENIOR MANAGERS (1998) (setting forth basic principles and approaches for dealing with fraud).

45. *Id.*

46. *Id.* at 16.

it is an endemic part of the corporate form and, for that matter, all human conduct. In the absence of civility and laws, there is no limit to the clever means by which man will conspire against his or her fellow man, whether from want of gain or merely boredom. Our systems of corporate law should attempt to bring peace and regulation to these former quarters of suspicion—broad equity ownership is a good complement to such efforts.