The Boundaries of "Team" Production of Corporate Governance

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ABSTRACT

We examine the cooperative production of corporate governance. We explain that this production does not occur exclusively within a "team" or "firm." Rather, several aspects of corporate governance are quintessentially market products. Like Blair and Stout, we view the shareholder as but one of many stakeholders in a corporation. Where we depart from their analysis is in our view of the boundaries of a firm. We suggest that they overweight the intrafirm production of control. Focusing on the primacy of a board of directors, Blair and Stout posit a hierarchical team that governs the economic enterprise. We observe, however, that for many of the most important governance decisions there is, in fact, no hierarchy. In those cases, governance emerges from an intertwined series of market transactions. To use the nomenclature of Blair and Stout, there are many players, but there is no coach, and thus, no "team." Rather, the firm is controlled by a series of relationships—some of which are governed within the firm and some of which are governed and enforced externally. Ours, then, is a true Coasean framework, suggesting that important implications arise when we differentiate cases where the value of market discipline on stakeholders exceeds the large transaction costs that could be reduced by integration or team creation from cases where the opposite is true. We provide some preliminary conclusions on those implications.

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"Yet having regard to the fact that if production is regulated by price movements, production could be carried on without any organization at all, well might we ask, why is there any organization?"

-Ronald H. Coase, The Nature of the Firm[1]

I. INTRODUCTION

The scholarly debate about corporate governance is stuck in a rut. The root of the problem is the excessive focus on the board of directors, either as the mediator between the interests of ownership and control, as the coach of a corporate team, or as an obstacle to the will of a broad collection of stakeholders.[2] Most theories to date either extol or decry the role and importance of shareholders (broadly thought of as "owners") within the board-dominated firm hierarchy. These theories approach the problem with different operating assumptions about whether the firm is premised on team production, property rights, or something else. But they generally end in one of two places: a discussion of how the board facilitates optimal governance or how it should get out of the way of adequate corporate reform. The goal of our project is to get the scholarly debate out of this rut by examining how recent corporate practices illuminate a different locus of corporate governance. Only if we understand where corporate governance truly resides are we able to effectively regulate corporate activity.

We start with Ronald Coase's insight that cooperation in the production of a good or service can happen in many ways, not all of which happen inside of a firm or even on a team.[3] Coase's famous question—"why is there any organization?"—made this point salient.[4] The bounda-

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1. R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 388 (1937).

2. *Compare* Kelli A. Alces, *Beyond the Board of Directors*, 46 WAKE FOREST L. REV. 783 (2011) [hereinafter Alces, *Beyond the Board*]; Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239 (2009); Stephen M. Bainbridge, *Response to Increasing Shareholder Power: Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. Rev. 833 (2005); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

3. Coase, *supra* note 1, at 388.

4. *Id.* Think about the production of an automobile. A young Henry Ford might assemble one from pieces bought entirely from a variety of suppliers, or an older Henry Ford might create a firm—the Ford Motor Company—that would own the entire supply chain, from mining to steel and rubber production to engineering, assembly, and distribution. There are an infinite number of alternatives between these two extremes. A middle-aged Henry Ford might do some of the work under the auspices of the Ford Motor Company, but buy engines from two brothers named Dodge. As market transactions become less costly, one could imagine examples that are more unusual: the end user could contract with dozens of market actors to produce each part and then dozens more to assemble them.

ry of the firm, he reasoned, is defined by the relative costs and benefits of organizing activity by fiat (that is, within a firm) or by market transaction.[5] The question for Coase and those who followed has always been: why do some productions follow the first model while others follow the second?[6] Our key contribution is to demonstrate that Coase's insight applies not only to the production of firm outputs, but also to the production of corporate governance.[7]

Governance, which we define as the locus and mechanisms of residual corporate control, is no different from the supply of other things to the firm.[8] It can be produced within a firm or by external market forces, and the choice will depend on the relative costs and benefits of each approach. We would expect some firms, at some times, to "build" their own governance while other firms at other times "buy" governance in the market. This choice, which was the focus of Coase's pioneering work, is plain in the production of goods and services. Apple Computer employees design the iPhone, but another company, Foxconn, builds them under contract with Apple. This is presumably because engaging Foxconn leads to a more efficient production.[9] While outsourcing is well understood in this context, the concept is equally applicable for corporate governance.

This is most obvious when a firm is in its early stages and contracts out governance to a group of venture capital funds or when a firm is underperforming and does the same with a private equity fund. In both cases, while there is still a board, and managers still run the firm, the real governance rights exist in a series of state-contingent contracts between the firm, its shareholders, and the investment funds. The contracts in both of these cases slice and dice control in sophisticated ways that presumably increase the value of the firm. As we explore below, in these and other related contexts, the board of directors—often thought of as the central node of control—is a bit player, if relevant at all. Real governance power lies elsewhere, and largely outside of the gaze of modern corporate law scholarship.

In other words, in economic production, cooperation can result from command ("Hey you, build me an engine") or from arm's length market transactions ("We'd like to buy this engine from you").

5. *Id.* at 388–89.

6. *See id.* at 389. A subsidiary question is how to differentiate the two in the first place.

7. By governance, we mean both a framework in which decisions about how a firm should be organized and operate are made, as well as the key decisions of the firm regarding certain actions, like compensation.

8. *See* Stephen M. Bainbridge & M. Todd Henderson, *Boards-R-Us: Reconceptualizing Corporate Boards*, 66 STAN. L. REV. 1051 (2014).

9. The source of this efficiency is generally thought to arise from the information or discipline provided by the market.

More generally, much of corporate governance today is not "built" or housed within most firms, but rather emerges from the combination of inputs produced in an external "market of governance." Stakeholders of all types exercise small bits of governance, and the whole of that governance exists in an indefinable space characterized more by market forces than command and control. If there is a suite of control rights that constitutes governance, its production is divided among the board, senior lenders, bond holders, venture capital firms, private equity firms, hedge funds, institutional investors, and the like. But that is not all. Additional suppliers of governance may include unions and customers.[10] All of these players exercise some set of the components that add up to the whole of corporate governance. And despite the incompleteness of the contracting among the players, a centralized authority or organization rarely arises to coordinate them. Our hypothesis is that this lack of a central organization is a salutary result. It is the market production that Coase identified as an alternative to integration and merely reflects the costs and benefits of exercising governance power.

We suggest, then, that the best way to view the governance of firms is as a product that investors and all other stakeholders desire. Like any product, this can be produced within a firm or in the market. Importantly, this choice is independent of the same choice about whether other aspects of firm activity happen inside or outside the firm. Governance for an automobile manufacturer can be entirely external while production of the automobile is fully integrated or vice versa.[11]

In Part II below, we contrast this view to the existing accounts of firms and corporate governance. We then explore the common forms of governance over large firms of various types. Our preliminary analysis is that, while corporate governance is produced both inside and outside of a firm, the most important aspects—decisions about capital structure, long-term goals, acquisitions, and mergers—often emerge from market transactions. Internal governance decisions usually cover things in the category of hiring, short-term production and marketing strategies, compensation, and the like. This draws into question laws and theories that elevate

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10. The role of outsiders was pointed out by Blair and Stout and has been examined by others. *See generally* Alces, *Beyond the Board*, *supra* note 2; Blair & Stout, *supra* note 2; Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006); Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309 (2008); Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115 (2009). Our goal here is to work out the contours and implications of that role.

11. Tesla, in its early stages, might be an example of the former, while GM may be an example of the latter.

the primacy of the board of directors. Internal hierarchies that may be described as teams (Coase's firm) might act in the direct production of the widgets that a corporation sells. But the governance structure for the firm is an organic network (Coase's ideal market production) that leads to the production of corporate control. They are distinct modes of production.

In Part III, we provide a number of examples that demonstrate the phenomenon we are illuminating; specifically, corporate governance can take place through the external controls created by market production. These examples primarily demonstrate the way in which creditors exercise control and handle problems of residual control using market-like mechanisms.

In Part IV, we explore the implications this has for the law of corporate governance and finance. For instance, the theory and practice that elevates the centrality of the board of directors, with attendant fiduciary duties, likely destroys value by limiting the ability of entrepreneurs and investors to contract in ways that narrowly tailor governance rights to optimize firm value. On the other side of the debate, attempts to curb board power by internalizing the market production of governance over the firm are equally misguided.

II. CHALLENGING THE EXISTING THEORETICAL LANDSCAPE

"My own favorite example is riverboat pulling in China before the communist regime, when a large group of workers marched along the shore towing a good sized wooden boat. The unique interest of this example is that the collaborators actually agreed to the hiring of a monitor to whip them."

-Steven N. S. Cheung, The Contractual Nature of the Firm[12]

While decades have been spent analyzing theories of the firm and of corporate governance, much disagreement and confusion remains. One strand of literature examined the role and value of a manager in directing team cooperation when market direction is costly or impossible.[13] Another strand, noting that theories of teams and hierarchies cannot explain the "firm" per se (as opposed to elaborate market arrangements), focused instead on property rights and the central ownership of assets as

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12. Steven N.S. Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1, 8 (1983).

13. *See generally* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Bengt Holmstrom, *Moral Hazard in Teams*, 13 BELL J. ECON. 324 (1982); Oliver E. Williamson, *The Vertical Integration of Production: Market Failure Considerations*, 61 AM. ECON. REV. 112 (1971).

the defining feature of the firm.[14] Thus, Grossman, Hart, and Moore introduced the idea of ownership of assets by one of the input providers (and the residual control rights that go along with that ownership) as the defining feature of a firm.[15] Alchian and Demsetz,[16] Holmstrom,[17] and others[18] focused more on the concept of a team that has deposited residual control in a neutral leader. These theories were criticized in part for ignoring agency conflict between owners and managers.[19] That critique obviously builds on the foundation of Berle and Means,[20] and Jensen and Meckling.[21] Still, others have simply viewed the firm as a nexus of contracts where various input providers, from employees to sophisticated lenders, come together to create one large productive relationship.[22] There is a general assumption in all of these works, however, that owners of the firm have, or should have, the power to define governance over the firm.

An alternative proposed by Margaret Blair and Lynn Stout is to view the firm as an example of "team production," with the board of directors serving as a "mediating hierarchy" that determines, calibrates, and cashes out the various interests of those who invest their assets in the firm. Blair and Stout summarize their idea as follows:

> [Our team production model] suggests that the legal requirement that public corporations be managed under the supervision of a board of directors has evolved not to reduce agency costs—indeed, such a requirement may exacerbate them—but to encourage the firm-specific investment essential to certain forms of team production. In other words, boards exist not to protect shareholders *per se*, but to protect the enterprise-specific investments of *all* the members

14. *See generally* Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990).

15. *See* sources cited *supra* note 14.

16. Alchian & Demsetz, *supra* note 13.

17. Holmstrom, *supra* note 13.

18. *See, e.g.*, Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECON. 387 (1998).

19. *See generally* Patrick Bolton & David S. Scharfstein, *Corporate Finance, the Theory of the Firm, and Organizations*, 12 J. ECON. PERSP. 95 (1998).

20. *See generally* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1932).

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

22. *See generally* Frank H. Easterbrook & Daniel Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

> of the corporate "team," including shareholders, managers, rank and file employees, and possibly other groups, such as creditors.[23]

The "team," in the Blair and Stout sense, is defined not by the presence of multiple stakeholders (or players), but rather by the existence and centrality of the board (or coach). The team production scholarship argues that incomplete-contracting problems in collaborative production can be addressed by appointing a third party who takes the lead when necessary to fill any contractual void.[24] The other team members voluntarily relinquish residual control to their mighty coach,[25] who in turn provides dispute resolution and other decisionmaking that mediates the interests of the various stakeholders in ways that maximize the value of the enterprise. To press the analogy from this Part's epigraph, the various corporate stakeholders are like the riverboat pullers in China, and the board is the third party hired to whip them.[26]

Blair and Stout rightly point out that concepts equating "ownership" and "control" do not quite work in the context of large public corporations.[27] This bold claim was premised on the fact that few owners of business firms exercise or desire to exercise any meaningful governance.[28] Once that point is recognized, the idea that theories of the firm ignore the agency problem between ownership and management becomes irrelevant. In this way, agency costs between the board and firm owners are a feature, not a bug of corporate law. These costs allow the board to pursue a number of things, including long-term value, values other than pure shareholder wealth maximization, and other socially valuable courses of action that may be sacrificed by the shareholder-dominated firm.

While we think Blair and Stout were correct in their critiques of theories of the firm that rely on the equivalency of ownership and control,[29] we part ways with them for precisely the same reason they parted

23. Blair & Stout, *supra* note 2, at 253 (emphasis added).

24. Alchian & Demsetz, *supra* note 13; Holmstrom, *supra* note 13.

25. In most models, this captain cannot be an independent provider of inputs—think the coach on the sidelines rather than the quarterback in the huddle. This distinction is not central to our inquiry here.

26. *See supra* text accompanying note 12.

27. Blair & Stout, *supra* note 2, at 260–61.

28. *Id.* ("If 'control' is the economically important feature of 'ownership,' then to build a theory of corporations on the premise that ownership (and, hence, control) lies with shareholders grossly mischaracterizes the legal realities of most public corporations."). We think this point is broader and applies to most sophisticated firms with complex capital structures.

29. Blair and Stout are no longer alone on this. There has been an increasing trend of scholars moving away from the shareholder-centric view. Even the most strident defenders of shareholder

ways with the pre-1999 literature: modern corporate behavior does not fit well with their theory of residual control being exercised by a very powerful board of directors.

Corporate governance today increasingly emerges from the bits and pieces of power produced in an external market of governance. Fitting the capital structure of today's sophisticated firms into the team model stretches the analogy too far. For instance, Blair and Stout suggested that perhaps creditors were within their team, meaning subject to the residual control of their coach, the board of directors.[30] In Steven Cheung's analogy, this would place them as riverboat pullers subject to the discipline of the whipping board. This placement gets things wrong.

Lenders do not deposit residual control of much of anything in the board. Instead, they undertake one or more of the following strategies: they may demand covenants that, upon breach, allow them to accelerate debt in a way that shifts residual control away from the board, or they may provide only short-term debt so that the board must routinely come back to the loan market and subject itself to that market's control.[31] When creditors use contract to acquire control rights, they create specific levers of governance that only they control—like veto power over debt-to-income ratios or residual authority to decide on large capital expenditures. When they rely on the market, the power is more diffuse and the guidance for firm managers may be less precise. But the residual authority of creditors is equally powerful.

Creditors may supplement these mechanisms of governance by acting through the board,[32] or they may bypass it altogether, as we will see. The reality is that the board has some governance rights in some circumstances, senior lenders have governance rights in others, and various junior lenders have governance rights in all kinds of other circumstances. However they do it, this lever of control over governance through debt contract has only become salient to academics in the last decade.[33]

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primacy have begun to consider the importance of the interests of other stakeholders in certain contexts. *See, e.g.*, Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 251 (2010).

30. Blair & Stout, *supra* note 2, at 253.

31. *See* Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73 (1993).

32. For example, they could take a board seat to get information. Randall S. Kroszner & Philip E. Strahan, *Bankers on Boards: Monitoring, Conflicts of Interest, and Lender Liability*, 62 J. FIN. ECON. 415 (2001).

33. *See* Baird & Rasmussen, *supra* note 10; Tung, *supra* note 10. Though, to be fair, Patrick Bolton and the likes of Saul Levmore and Barry Adler were certainly aware of it when they examined the tools of creditor monitoring. *See* Philippe Aghion & Patrick Bolton, *An Incomplete Con-*

But our point goes deeper than just identifying lenders as monitors who are outside the total control of the board. While the existing literature has highlighted the relationship the lenders have with and over the firm, the next step is to dig into the relationship among creditors and analyze the relationships those creditors have with other external stakeholders. All governance of modern corporations happens both inside and outside of the firm, as it is currently conceived. Like creditors, all stakeholders sometimes are passive and sometimes exercise total control, as in the venture capital or private equity case. Other investors achieve similar control simply through their threats to buy and sell shares, as in the case of hedge funds. Individual funds or funds acting in groups (sometimes called "wolf packs") can use purchases, or the threat of a purchase, or short sale as a means of exercising control. There is some evidence this indirect control has positive benefits for firm stakeholders.[34]

A more expansive view of the market for corporate governance reveals not one team, but rather a collage of groups contracting on the market—some that are independent and others that are overlapping. We see governance as more evolving and organic than can fit into the rigid models of centralized corporate governance in the academic literature.[35]

To see the larger point, consider that the agreements (both explicit and implicit) between and among creditors, as well as the background laws allocating the suite of control rights, are riddled with incomplete provisions and open questions. This makes governance a fertile ground for the emergence of a firm, or a team production model, through which production of governance would be managed. Yet no grand firm or team has emerged. Despite the incompleteness and diffusion of the monitoring and control of corporate conduct, governance remains largely determined by market forces rather than a powerful board.

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tracts Approach to Financial Contracting, 59 REV. ECON. STUD. 473 (1992) (examining debt agreements as tools to induce profitable behavior); Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. POL. ECON. 1 (1996) (modeling effects of loan terms on lowering strategic default incentives); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Adler, *supra* note 31.

34. *See generally* Alon Brav et al., *The Returns to Hedge Fund Activism*, 64 FIN. ANALYSTS J. 45 (2008).

35. Our analysis here is similar to and draws inspiration from G. Mitu Gulati, William A. Klein & Eric M. Zolt, *Connected Contracts*, 47 UCLA L. REV. 887 (2000). They suggest that there are no firms and propose that the best analogy for a firm is a web of connected contracts. We think they are half right. The connected contracts theory is accurate if limited to the production of governance. But the Coasean notion of a hierarchy that organizes the production of the widget or automobile is still very much useful and should not be rejected. *See infra* note 95 and accompanying text.

For instance, consider the case of a corporate borrower that defaults on a note, say by its debt-to-income ratio rising above a set limit in violation of a covenant.[36] At that point, control of the firm is in flux and indeterminate. Even if the firm is performing well in real terms, the lender can call a technical default to extract rents. Equity and management can, however, respond with a threat of bankruptcy or other maneuvers that are costly to lenders.[37] The uncertainty and costs of potentially opportunistic behavior in this situation are factors that are thought to lead to integration or the delegation to a coach to manage the relationship. But that integration does not happen here. Rather, the costs of the market transactions to sort out the locus and levers of control are still low enough for governance to remain a market product. On the other side of the same coin, the costs of integration and allocation of control, to the board or other team leader, are high enough to force governance into the market.[38]

Finally, critiques of the board and reports of, or calls for, its total demise miss the point. To a large degree, the role of the board is irrelevant. It is just one means of centralizing decisions that occur within the firm. If the board was removed, a firm's internal decisions would be produced by a management committee or a lone CEO (the equivalent of a one-person board). These considerations are peripheral to the main inquiry. The specific organization of internal decisions is of little importance when compared to the question of which things happen internally and which happen in the market.

Thus, solutions focusing on the board or treating contracts inside the firm the same as those outside the firm get it wrong. For example, proposals to restructure the board or to create investor boards made of representatives of primary stakeholders would artificially expand the firm to encompass market relationships that have resisted integration. In

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36. This happens quite often in practice. Victoria Ivashina & Anna Kovner, *The Private Equity Advantage: Leveraged Buyout Firms and Relationship Banking*, 24 REV. FIN. STUD. 2462, 2467 (2011) ("Typically, bank loan covenants are set close to default levels."). Triggers set to go off only when absolutely needed do not give lenders sufficient leeway to avert problems before they arise. Anthony J. Casey, The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement, YALE L. J. (forthcoming 2015).

37. Prepayment penalties can make it difficult for debtors to use refinancing as a threat to counter this action. Then again, bankruptcy may, in some cases, nullify those penalties. The ability to contract around that outcome is uncertain. *See, e.g.*, *In re* AMR, 730 F.3d 88 (2d Cir. 2013) (exploring the law on make whole penalties); *see also* Casey, *supra* note 36.

38. One of these costs is that integration into a single firm producing governance may make it difficult to maintain the discipline and incentives from market participation, such as state-contingent penalties on various input providers. *See* Aghion & Bolton, *supra* note 33; Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 COLUM. L. REV. 1 (2013); Bolton & Scharfstein, *supra* note 33; Casey, *supra* note 36.

the leading such proposal, Professor Kelli Alces suggests the novel concept of an "investor board" that places "a collection of activist investors at the top of the corporate hierarchy."[39] She notes that her investor board would be "better at performing both board functions."[40] As we suggest throughout, scholars like Alces are starting from the right insight: market contracts play a large role in corporate control. She relies, in part, on the insight made by Douglas Baird and M. Todd Henderson that the law of fiduciary duties is outdated and flawed and that agreements with market participants should be respected.[41] This is true, and Alces's analysis sheds enormous light on the problems inherent in corporate law's focus on the board. The solution to that problem, though, is not an expansion of the firm to bring market transactions into the hierarchy. That would interfere with market production in novel, but equally problematic ways.

Alces's analysis comes closer to ours when she proposes that the investor board may someday whither away "allowing the network of investor contracts . . . to perform the functions once delegated to the board of directors."[42] That proposal, however, goes too far in the other direction and externalizes those things that have consciously been integrated. Our point is that the network of investor contracts already performs many corporate governance functions, while the board performs other functions that are more appropriately contained within the firm. Like Alces, we worry that there are sets of decisions where the law artificially places the board at the helm of market functions. But bringing external decisions into the firm in the hope of one day pushing internal decisions out is counterproductive to the market for corporate governance. The obstacles holding back some market functions, which we discuss below, have nothing to do with the existence of the board but rather, (1) the conflation of internal and external governance where market decisions are forced into internal management hierarchies, and (2) the long-recognized failing of fiduciary duty law. Put another way, the solution lies not in eradicating the board of directors, but rather in delineating its boundaries and abandoning the false notion that it is at the core of the analysis of corporate governance issues.

A Coasean theory of the firm leads to the appropriate remedy—it allows us to differentiate between contracts that are enforced by courts

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39. Alces, *Beyond the Board*, *supra* note 2, at 813.

40. *Id.* at 823.

41. *Id.* at 816, 817 (citing Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1339 (2008)).

42. *Id.* at 836.

and those that are enforced by the hierarch.[43] Some agreements are entered into and enforced within the hierarchy; others are played out in the open market. The line between the two was at the heart of Coase's definition of the firm, and we should not conflate those two types of relationships.

To get a better sense of the phenomenon we are beginning to describe, it is worth taking a closer look at specific examples of the way in which creditors exercise control and handle problems of residual control using market-like mechanisms.

III. A LOOK AT THE MARKET PRODUCTION OF CREDITOR GOVERNANCE

Creditors occupy an important place in this governance constellation. In some places, like in much of Europe and Asia, banks fund much of the debt side of corporate balance sheets, and, as holders of this debt, exercise direct and explicit control over much of corporate decisionmaking. In other places, as in most firms in the United States today, debt is more likely to be held by a diffuse group of bond holders with little explicit control over governance other than that created by the need of the borrower to return to the bond market. In the United States, bonds represent about half of debt funding, while in Europe, vanilla bank loans are much more important.[44] There are also hybrid cases in which creditors hold a more complex security, such as preferred shares, and the "lender," like a venture capital fund, exercises a range of control rights by contract and by industry custom. These funds often occupy a central role in an even more complicated firm structure with several layers of active investors and managers. The investment instruments the firms use are not quite analogous to traditional debt or equity, but the investment funds (and not the board) are undeniably at the hub of a massive team of governance.

But even with the inclusion of this hybrid case, the picture is still incomplete and highly misleading. Instead, many types of corporate funders participate in debt interests of innumerable variety, often in compli-

43. This distinction of the locus of enforcement is important in Margaret Blair's work and is hinted at by other theory-of-the-firm scholars. *See* Margaret M. Blair, *Firm-Specific Human Capital and Theories of the Firm*, *in* EMPLOYEES & CORPORATE GOVERNANCE 58 (Margeret M. Blair & Mark J. Joe eds., Brookings Inst. Press, 1999). Anup Malani and Richard Holden have suggested that this is *the* defining characteristic for a legal theory of the firm. Anup Malani & Richard Holden, A Legal Theory of the Firm (July 21, 2014) (unpublished manuscript) (on file with author).

44. Org. for Econ. Co-Operation and Dev., *Non-Consolidated Financial Balance Sheets by Economic Sector (Quarterly table 0720)*, OECD.STATEXTRACTS (Sep. 27, 2014, 20:38 UTC), http://stats.oecd.org/Index.aspx?DataSetCode=QASA_TABLE720.

cated and shifting ways that defy easy categorization. The providers of debt—ranging from venture capital firms (for startups) to private equity firms (for turnarounds), from banks to bondholders, and from insurance firms to individual investors—are increasingly diffuse with no hierarchy, and are governed by a web of decentralized contractual and quasi-contractual arrangements. These market-based contracts are nimble in how they adapt to changing rules and market conditions.

Next, we will consider a series of simplified examples that demonstrate our claim. The first example is a relatively simple case in which a borrower has multiple liens on a particular piece of collateral. The lien holders may enter into a standstill agreement in which the second lien holder gives up some control over its collateral. But likewise, the first lien holder has given up some of its control by consenting to the existence of the second lien holder. These agreements are ubiquitous in modern corporate finance. How then do the lien holders resolve their governance rights with respect to the collateral in question, which, after all, is only valuable as an input into one corporate process or another? The concrete answer is through a contract, known as an inter-creditor agreement. These agreements do not, however, assign *residual* control to one lender or the other, or to the board (or to a Chinese guy with a whip, as described *supra* in Part II). The standstill agreements have terms that will be enforced by courts, but also contain limits that leave open space for disagreement. Where those terms are incomplete, *ex post* haggling in the market takes over. Notice the board is nowhere in this account, but control over a particular asset of the borrower is clearly at stake.

The second example involves the role a senior secured lender plays in the governance of large private and public firms. While there is a dispute in the literature about whether secured or unsecured debt engages in more general monitoring of corporate decisionmaking,[45] debt contracts often contain terms by which junior creditors rely heavily on senior creditors to provide monitoring signals, even when their own interests may create incentives to do otherwise. For example, "anti-layering" provisions delegate to the senior lender the decision on how risky junior bonds will be. The anti-layering provision might provide that the borrower cannot take on debt that falls between the bonds and the senior secured creditor.[46] Notably, other terms of these debt contracts would allow the bor-

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45. *See* Adler, *supra* note 31.

46. C. Edward Dobbs, *Negotiating Points in Second Lien Financing Transactions*, 4 DEPAUL BUS. & COM. L.J. 189, 191 (2006).

rower to expand its debt under the existing senior loan.[47] In theory, a bondholder should be indifferent between a debt structure where there is \$2 million in first lien debt and a debt structure where there is \$1 million in first lien and \$1 million in other senior debt. Yet the typical anti-layering provisions allow the first option and not the second one. In this way, the junior creditors are relying on the senior lenders to test the risk that is tolerable—perhaps because of the senior lenders' expertise, information, and reputation in a repeat-play game. Monitoring of corporate activity, here, is being exercised by and among various lenders and types of lenders in ways that bear directly on corporate policy and that largely resist an integrated governance structure.

A third example involves agreements in modern lending syndicates. These agreements are instructive of the nebulous and market-based aspects of control by and among lenders. As a base case, if a single lender fails to fund a draw on a revolving debt facility, the debtor has a setoff remedy when the lender pursues contractual payments such as scheduled commitment fees. But what happens when the debt is held by a syndicate of banks and not all banks fail to fund? This possibility arose when the financial crisis hit in 2008, as many banks, like Lehman Brothers, could no longer fund their loan obligations in open credit facilities. This presented thorny issues for borrowers and lenders under syndicated credit facilities.

In a liquid market, "yank-a-bank" provisions in the agreement might have allowed for the replacement of the defaulting bank with another lender.[48] But in 2008 and 2009, there were many situations where no such alternative lender existed.[49] That raised a new set of problems for the borrowers and the nondefaulting lenders.

As one might expect, the collective action problem had been addressed *ex ante* by appointing an administrative agent to make certain decisions when disputes arose. The administrative agent might be thought to be the coach of the creditor team, but that is not accurate. The agent's control is limited by the contract and is not residual. Perhaps surprisingly for the theory of teams, the credit facilities often contained only

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47. Indeed, some anti-layering provisions are interpreted to allow second lien financing and only prohibit senior debt that otherwise subordinates the bondholders. FITCHRATINGS, OVERVIEW OF THE U.S. SECOND LIEN LOAN MARKET 4 (2006), *available at* http://pages.stern.nyu.edu/~igiddy/articles/us_second_lien.pdf; Dobbs, *supra* note 46.

48. *See, e.g.*, Robin J. Miles et al., *Syndicated Lending Update: Defaulting Lender Issues*, 126 BANKING L.J. 165, 166 (2009) (describing yank-a-bank provisions).

49. David L. Betty, *Necessity is the Mother of Innovation During the Credit Crisis*, 14 N.C. BANKING INST. 1, 7 (2010).

vague provisions for dealing with the defaulting lender problem in the syndicate, and the agent was not given residual or gap-filling authority. Under many of these loans, the administrative agent was arguably required to distribute payments from the debtor among the lenders regardless of their failure to fund new borrowing.[50] Fearing a lawsuit, an agent's best defense would be to act mechanically under the terms of the agreement. Thus, any setoff by the borrower would have caused a pro rata underpayment to all of the funding lenders and a breach by *the borrower*. This creates a multilateral standoff among all of the lenders as well as the borrower.

A banal, but important, observation from this case is that the costs of assigning residual authority exceed the benefits for these lending syndicates, at least in the underfunding case. The story we can tell here is relatively straightforward. The banks in the syndicate are repeat players with large reputations, and any opportunism or advantage taking in one case is likely to be repaid in another. But there are more interesting aspects to this example. First, the opportunism here is entirely predictable, and therefore any incomplete contracting cannot be attributed to a lack of imagination, but rather something else. Second, the contracts among lenders do not just impact the lenders, but also interact with the control of the borrower. In other words, the incompleteness and the lack of a coach are features of the corporate governance of the borrower. Again, the board is nowhere in this picture.

A fourth example involves the behavior of creditors in bankruptcy. When Chrysler went into bankruptcy, the members of its lending syndicate found themselves at odds with each other.[51] The majority of lenders in the syndicate had received TARP funds and were each assumed to be in constant communication with the federal authorities with regard to the automotive industry as well as the financial crisis more generally. President Obama even appointed a "czar" to manage the government's dealings with the auto industry. A small minority of lenders was not beholden to the federal government. As the federal government was the primary supporter of the Chrysler bankruptcy plan, the minority was suspicious when the majority voted to present a gift of value from all senior lenders to the United Auto Workers. But the secured loan facility contained vir-

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50. *See* Miles et al., *supra* note 48, at 167 ("Most syndicated credit agreements do not expressly relieve the borrower of its obligation to pay commitment fees to a defaulting lender.").

51. Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727 (2010).

tually no terms limiting the ability of the majority to vote in favor of a bankruptcy plan.[52]

A similar scenario emerged when, in 2010, the Third Circuit allowed debtors to prohibit credit bidding.[53] In the wake of this decision, lenders publicly worried that they had lost a tool for quelling dissent among their ranks. Without the ability to credit bid, the participants in credit facilities had no obvious means for preventing a holdout lender from destroying value for the group as a whole. Again, the contracts were silent on exactly what to do in these circumstances. The law firms and blogs were abuzz with suggestions on how to rewrite contracts or even change from syndicated loans to smaller loans with individual banks.[54]

A fifth example is about venture capital investments in startup firms. It is hard to categorize venture capitalists into any class of investor. Traditionally, the investment they make is in the form of preferred equity. Their decision to demand a board seat along with the investment turns on how big a stake one firm takes, how many other venture capital firms are involved, and other particulars of the firm they are investing in. One might expect that where several firms invest and one takes a role on the board, there is some sort of reliance between these firms. But such agreements are tacit, if they exist at all, and they do not generally delegate residual authority to anyone, least of all the board of the startup.

It should also be noted that the venture capital firm might not be the only investor. Venture debt may be overlaid in the capital structure. Here the workings of the team come into play. There are only a handful of banks providing major venture debt. They pick their projects by looking

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52. And certainly nothing specifically covering a scenario where the majority was coerced into accepting a plan by the federal government. For in-depth looks at the various moving parts in the Chrysler and GM Bankruptcy, see Barry E. Adler, *A Reassessment of Bankruptcy Reorganization After Chrysler and General Motors*, 18 AM. BANKR. INST. L. REV. 305 (2010); Ralph Brubaker & Charles Jordan Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of Chrysler and GM*, 2010 U. ILL. L. REV. 1375 (2010); Roe & Skeel, *supra* note 51; Douglas G. Baird, *Lessons from the Automobile Reorganizations*, 4 J. LEGAL ANALYSIS 271 (2012).

53. *In re* Phila. Newspapers, LLC, 418 B.R. 548, 552 (E.D. Pa. 2009), *aff'd*, 599 F.3d 298 (3d Cir. 2010).

54. Credit bidding allowed a lending syndicate to take actions in a bankruptcy to secure full recovery without requiring the members of the syndicate to pony up additional money. Many think that plans that are proposed without credit bidding are intended to take advantage of discord among lenders in a syndicate. *See* Randall Klein & Danielle Juhle, *Majority Rules: Non-Cash Bids and the Reorganization Sale*, 84 AM. BANKR. L.J. 297 (2010). In the end, the Third Circuit's holding was overruled in *RadLax Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012). But the issue has reemerged in a different form in the recent *Fisker* case. *In re* Fisker Automotive Holdings, Inc., 510 B.R. 55 (Bankr. D. Del. 2014). Once again, practitioners we have spoken with are mulling over the decision to change contracts or make other changes.

at what the venture capital firms they know are doing. To be sure, the venture banks do their own due diligence before investing, but they will not even start the process until they know a reliable venture capital firm has vetted the investment.

But the signaling and reliance goes both ways. Banks compete heavily to be the lender of the best projects. This means that successful venture capital firms can pick and choose. New entrants are not trusted. And banks that exited during the recession without trying to create value won't be welcomed back favorably. As a result, venture capital firms can negotiate for favorable terms with credible banks. But it also means that they are not as concerned with technical covenant defaults as they are with the reputation of the bank.

In this environment, the terms of lending contracts are less important than one might think given the presence of alternative methods of discipline—lots of covenants, or few covenants, are equally likely to result in the optimal exercise of control since borrowers can reject lenders tomorrow who abuse them today. Accordingly, while there was little that venture capital funds could do when some venture banks became trigger-happy with their covenants in the depths of the Great Recession, those trigger-happy banks are no longer welcome in that investment community; those that remain understand that such behavior has its consequences. Markets work, and sometimes provide discipline that is a compliment to, or substitute for, explicit contracts or delegated control.

The final, related example involves private equity fund investments in portfolio companies. There is conflicting data on whether lenders tend to lighten their covenants in repeated dealings with private equity firms in investments, including leveraged buyouts (LBOs). Some have suggested that the covenant intensity should go down as the private equity firms provide a signal of the quality of the investment, which reduces the costs of asymmetric information.[55] Others have suggested that the private equity firms often have higher leverage and that provides opportunity for greater risk taking, and thus, requires the lender to use more restrictive covenants.[56] The data is mixed, however, providing no easy answer to which of these stories is more accurate.[57]

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55. *See* Ann-Kristin Achleitner et al., *Structure and Determinants of Financial Covenants in Leveraged Buyouts*, 16 REV. FIN. 647 (2012); Ivashina & Kovner, *supra* note 36.

56. Achleitner et al., *supra* note 55.

57. *Id.*; Cem Demiroglu & Christopher M. James, *The Role of Private Equity Group Reputation in LBO Financing*, 96 J. FIN. ECON. 306, 306–09 (2010); Ivashina & Kovner, *supra* note 36; *see also* Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING FIN. L. 115 (2013).

But there is another possible factor: the lenders are competing to provide loans to private equity funds. Just as a lender gets a signal from a reputable private equity firm, so too does a private equity fund (or venture capital fund) have lenders it trusts and lenders it does not. It may be that a trusted lender can be relied on not to exercise heavy covenants in a destructive way, whereas an unknown lender might be trigger-happy. If this were true, we would see heavy covenants in repeated relationships, while the junior investors might demand lighter covenants from unknown lenders. At the very least, this is an important dynamic in the negotiation of covenants in any deal.

While seemingly remote from any discussion of the theory of the firm, an obvious lesson from these examples is that even the most sophisticated loan agreements are incomplete and riddled with potential for opportunistic behavior. They, like all other contracts, are incomplete and have no allocation of residual control.

A reader familiar with organizational scholarship on team production would expect this to be fertile ground for the emergence of a "team" in the spirit of Alchian and Demsetz, Holmstrom, or Blair and Stout. Or, more abstractly, one might expect a delegated third party be vested with residual authority to arbitrate contract disputes among the parties and to provide a gap-filling role. Across the myriad capital structures found in today's business world, no such team has emerged. There is no coach, only players. The market has apparently determined that the cost of doing business in that environment is worth it compared to the cost of integrating.

That is not to say that every lender is an island. Lenders continuously collaborate with each other, with management, and with other stakeholders. But they do so as independent players dealing at arm's length with no central leader. Discipline for opportunistic behavior does not come from above but rather from the flanks. Where contract terms fail, reputation, norms, and other relational mechanisms provide protection for market participants.

By itself, this observation is nothing new. Teams emerge in some production functions and not in others; informal contracting and norms dominate many markets.[58] That lenders do not rely on a team structure does not undercut team production theory writ large. But our observation should not be taken by itself. There are two other factors that complicate our view of corporate governance. First, there is an increasing variety of

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58. *See generally* Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992).

entities that provide investment and many types of debt. And for any given amount of debt, there are even more holders of that debt. The securitization market, which is flourishing for corporate debt, is an example of this phenomenon. The second is that providers of debt are playing an increasing role in corporate governance.

Putting these observations together creates a new topography of corporate governance. Others have said governance is not just about shareholders, the board, workers, and so forth, but also about lenders and others who exist outside the firm. What we add to their observations is an exploration of the production function that these outsiders are part of. Their influence comes neither from an isolated lender pulling a control lever nor from a team of lenders who have submitted to the leadership of one trusted bank. Nor does it come from a hub-and-spoke relationship with lenders, each making a bilateral, single agreement with the board. Instead, investors produce a suite of enforcement rights (formal and informal) that they separate and allocate in endless combinations with the rights of other investors and controlling parties. And the actions of one outsider exercising its subset of rights have ripple effects throughout the entire capital structure. Those actions are not policed by a hierarchical manager even when contracts are powerless. Instead, the corporate governance produced at the hands of lenders is an organic force that is poorly understood. In this way, our project looks to take the creditor governance literature as a jumping off point for further inquiry.

IV. Some Tentative Implications

Although we have not done nearly enough work in describing the new corporate governance milieu to draw any strong conclusions about what it all means, we will take a moment to lay down a brief marker that will hopefully be an inspiration for future work.

A. The Distortion Caused by Fiduciary Duties

In modern corporate governance scholarship and practice, the board of directors is where all the action is. A leading theory of the firm is called "director primacy," since it makes both a positive and normative case that the board should be the central node of all governance.[59] Critics of the board even acknowledge its centrality. They just believe shareholders, or maybe workers or politics, should have a greater influence in who sits in those chairs. In all these accounts, fiduciary duties are the

59. *See* Bainbridge, *supra* note 2.

mechanism through which the board's allegiance to the "owners" or "stakeholders" is vindicated. We believe these stories are as untrue as they are dangerous.

The control exercised by creditors and other investors often happens to include boards on which the investors take a seat. But it is difficult to know if the boards serve any purpose or are just a means to comply with a meaningless formal requirement.[60] As a mere formality, they should do no harm. The concern is that the judicial and scholarly obsession with boards leads to other distortions. Thus, venture capital investors sitting on a board might use the board as an informal means for negotiation of market contracts.[61] The courts might, however, miss the nuance and inject the rules governing internal firm decisions into these market transactions just because they are being conducted among members of the board.[62] The fear is that a variety of market transactions will artificially be forced within the firm. This can have real costs. For instance, if every decision runs through the board, then fiduciary duties begin to creep out to market relationships in perverse ways.

In most cases, fiduciary duties are just an aspirational statement of how directors "should" behave, with little legal force behind them.[63] Fiduciary standards may have some power in providing guidance to directors who take their stated "duty" seriously without external enforcement. That can be valuable if the duties are correctly identified, but also problematic if incorrectly identified—such as when they suggest that the internal power of the board can trump the external market.

But when the duties *are* enforced, it is with little predictability and sometimes can be used to invalidate a market transaction that should not be governed by fiduciary duties.[64] *Omnicare, Inc. v. NCS Healthcare, Inc.*, is the most egregious of such cases.[65] These uncertain applications of duties are difficult to contract around and are therefore hard to avoid.

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60. *See* Robert P. Bartlett, *Shareholder Wealth Maximization as Means to an End*, 38 SEATTLE U. L. REV. 255 (2015). We suspect it is the meaningless formality.

61. *Id.*

62. *See, e.g.*, *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 33 (Del. Ch. 2013).

63. The business judgment rule and the courts' ability to distinguish cases based on subtle nuance prevents much of the stated duties from being enforced.

64. *See* Baird & Henderson, *supra* note 10.

65. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003). In *Omnicare*, the Delaware Supreme Court infamously invalidated a set of lock-up provisions that enabled a failing company to find a buyer and avoid almost certain bankruptcy because the provision did not give the board of directors the option to back out of the deal if a better offer arose before the deal closed. The Chancery Court's rhetoric in the *Trados* litigation has a similar flavor. *See In re Trados*, 73 A.3d 17. But there the court was able to avoid finding liability for the directors based on a questionable factual finding. *Id. See also*, Bartlett, *supra* note 60.

When courts are not just randomly enforcing fiduciary duties, generally speaking, the outer bounds of acceptable behavior for directors approaches something along the lines of fraud. That outer bound is acceptable because the market does what the law cannot: it punishes incompetence and conflict that is short of fraud. And it does so on all levels, not just for one group of investors. The idea that without fiduciary duty law corporate governance would collapse into widespread tunneling of assets and other forms of theft is not a serious claim. Blatant fraud is illegal regardless of fiduciary duties. Other forms of conflict that lie in a gray area are as likely to lead to market reaction as any legal process based on fiduciary duties is to incent the right conduct.

The recent *Trados* litigation exemplifies the deification of the board and a misapplication of fiduciary duties.[66] The court reasoned that a venture capital investor sitting on the board of directors was required to protect the option value of equity.[67] The problem is that this creates a strange world where creditors exercising power they bargained for in a private company are now subject to fiduciary duties to equity because they happen to take a seat on the board. It is entirely plausible that venture capital funds take equity interests not because they want a seat on the board but because they want control that is easy to trigger. With well established companies, lenders are happy to have covenants that are triggered by familiar problems. But with a startup, the investors do not know what signal of distress they will receive. All investors want options in responding to signals of failure;[68] venture capital investors demand the broadest of options. They want to be able to vote for a change of course without calling a default. Incidental to acquiring that power is a seat on the board of directors—where equity has to go to flex its muscle by default. But the result of obtaining that seat is that the courts may impose vague notions of fiduciary obligation on the investors that begin to look like lender liability for venture capital firms.

This creates an unfortunate thicket of legal obligations for what would otherwise be a straightforward contractual relationship between an entrepreneur and investors.[69] Moreover, the idea of duty to maximize option value is one that is in conflict with even the concept that a board

66. *See In re Trados*, 73 A.3d 17.

67. *Id.*

68. *See* Casey, *supra* note 36; *see, e.g.*, *In re* AMR, 730 F.3d 88 (2d Cir. 2013) (exploring the law on make-whole penalties).

69. Particularly troubling is the idea that the duties in *Trados* are invoked for a closely held business with a small group of stakeholders dealing directly with one another. *See In re Trados*, 73 A.3d 17.

must maximize the value of the firm.[70] In the end, the *Trados* court avoided any real implication of its rhetoric by finding that the option value was zero.[71] But that convenient fact is unlikely to present in every case where an investor protects its bargained-for rights at the expense of an entrepreneur.

The solution is not to change the structure of the board, but to differentiate between how the law treats external and internal governance relationships. Indeed, it may require more nuance than just abandoning fiduciary duties. To the extent that fiduciary duties are relevant, they may provide a baseline for the resolution of disputes within the firm's hierarchy.[72] They should then be cabined to the internal workings of the firm. For example, it may be reasonable for an employee to assume that a decision to move her from department X to department Y will be made with the best interests of the firm in mind, and not out of animus or the self-interest of the division manager—at least when no outside parties have a say in the decision. Similarly, where two divisions of a conglomerate enter a contract arbitrated by the hierarch[73] there may be a background assumption that, in the absence of a statement to the contrary, the contract will be interpreted and enforced to the benefit of the enterprise as a whole.[74] Of course, this would only work if subject to the most broad business judgment presumption. One can still imagine that a baseline of maximizing the value of the enterprise could serve significant value when dealing with internally arbitrated governance decisions and could affect the interests of those who have made significant relationship-specific investments.[75] But the baseline is entirely inappropriate when addressing the relationships between various actors in the external market. If a loan agreement provides that a worker shall be moved from department X to department Y, then the only question is whether that loan agreement was validly executed.

This problem is manifest most for public companies, where fiduciary duties are most rigorously enforced and board actions most scrutinized *by shareholders*. In public firms, large shareholders, including institutions, hedge funds, and takeover specialists like Carl Icahn, play the

70. *See* Baird & Henderson, *supra* note 10.
71. *In re Trados*, 73 A.3d at 33.
72. *See* Blair, *supra* note 43.
73. *See, e.g.*, Malani & Holden, *supra* note 43.
74. This idea would find support, also, in the concept of the implied covenant of good faith.
75. *See* Blair, *supra* note 43.

most important role in governance.[76] Lenders take a decided back seat, in large part because of the robustness of the fiduciary duty regime in limiting freedom of contract, and thus disabling lenders' and other stakeholders' main mechanism of interest protection. Blair and Stout may argue correctly that the business judgment rule gives boards latitude.[77] But at least in judicial rhetoric, the idea of shareholder wealth maximization is strong, and fiduciary duties are understood to be about protecting the interests of shareholders.

And that rhetoric seems to have some bite in practice. Indeed, the idea of shareholder maximization maintains a sort of hypnotic power over courts, boards, funds, and pundits alike—even in insolvency cases where one would expect the duty to shareholders to be extinguished. Thus, in the *Trados* case, discussed above, the board had to show that the transaction at issue was entirely fair to equity, despite the fact that the firm was insolvent. The ongoing litigation over Fannie Mae and Freddie Mac is an even more egregious example of this.[78] Hedge funds have flocked to the courts to challenge the idea that a board of a hopelessly insolvent company might be able to consider the interests of stakeholders other than out-of-money equity.[79] They appear to claim that, by not favoring the option value of the out-of-the-money shareholders, the managers of Fannie Mae and Freddie Mac breached their fiduciary duties to those shareholders. Richard Epstein has gone as far as declaring the government's action in the case to be a taking.[80] But before one can have a taking, one must establish that there was something to take. One could only get there by falling under the spell of the shareholder-maximization sirens.[81]

B. Deemphasizing Shareholders Emphasizes Shareholders

A related point is that there is an irony of the Blair and Stout criticism: their attempt to *deemphasize* shareholders by running governance

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76. *See generally* Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449 (2014).

77. Blair & Stout, *supra* note 2, at 299–300.

78. *See generally* Adam B. Badawi & Anthony J. Casey, *The Fannie and Freddie Bailouts Through the Corporate Lens*, 10 N.Y.U. J.L. & BUS. (forthcoming 2014) (describing the various arguments and issues in the Fannie and Freddie litigation and collecting sources).

79. *See id.* (analyzing the Fannie and Freddie debate and noting the lack of a coherent argument that there was value taken in 2012).

80. Richard Epstein, *When Our Government Commits Fraud*, DEFINING IDEAS (Mar. 3, 2014), http://www.hoover.org/research/when-our-government-commits-fraud.

81. *See* Badawi & Casey, *supra* note 78.

through the board turns out to actually *empower* shareholders to be the most powerful voice in governance. As noted above, stakeholders of all kinds (be they creditors, workers, or communities) can, and do, protect themselves using contracts. These contracts are versatile, customizable, and adapt rapidly to changing legal and market conditions. But when all governance is routed through a board of directors, as Blair and Stout argue and wish for, then these contracts are inherently limited in what they can accomplish. Fiduciary duties are vague and give boards wide latitude, bounded only by somewhat unpredictable judicial interpretation. But they also create strange litigation options in the form of implicit or required fiduciary outs. This means that the ability of creditors and other stakeholders to tailor corporate governance to their ends is limited.

Lenders can still maintain influence through the use of covenants. They can easily negotiate for priority through security interests. They can carve out special withdrawal rights with entity partitions.[82] Or they can create selective enforcement options. These levers of control over the board are clear and formal. They are also more difficult for other stakeholders to contract for or to enforce in a board-centric world.

Two potentially value-enhancing possibilities are more difficult in a board-centered regime. First, nonlender stakeholders may have more difficulty contracting in the way lenders do, and therefore may be disfavored in this regime.[83] Take the litigation involving craigslist and eBay as an example.[84] The community of users of craigslist's free market was an undeniable stakeholder; without that community, craigslist would not exist. There is some kind of informal and implicit agreement between the firm and that community. If craigslist upsets them, the whole thing could tank. But despite all the talk about the business judgment rule and the suggestions by academics that *Dodge v. Ford*[85] is dead, the Delaware Chancery court stated explicitly that protecting that community was not a proper act of a board of directors of a corporation.[86] And that was a closely held corporation with only three shareholders where the holders of an overwhelming majority of shares approved of the action![87] If the firm cannot react to the governance market, value will be lost.

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82. *See* Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 COLUM. L. REV. 1, 8 (2013).

83. We draw on Professor Alces's insights here. Alces, *Beyond the Board*, *supra* note 2.

84. *See* eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1 (Del. Ch. 2010).

85. *See* Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

86. *See eBay Domestic Holdings, Inc.*, 16 A.3d 1.

87. The court also expressed some skepticism about the actual motivation for the board's actions. Those factual matters may have driven the outcome of the case. But the legal standards an-

Similarly, it is much harder to imagine how employees or unions could contract for the same efficient rights that lenders do. In the case of Chrysler, the gift to unions may have been necessary to enforce the practical control rights that the unions possess. But the law as many understood it made that gift illegal and subjected the outcome to criticism. This issue plagues many bankruptcies today as courts struggle to define the limits of gifting and the new value exception.

Second, fiduciary duties can prevent lenders from acting in ways that may enhance firm value. Randal Kroszner and Philip Strahan's work regarding bankers serving on corporate boards provides evidence of a board-centric model limiting innovation.[88] In a board-centric world, bankers may sit on boards as a means of influencing governance and of obtaining information. Sure enough, about one-third of U.S. large firms have a banker on their board.[89] Up to a point, Kroszner and Strahan find that bank monitoring of this type increases the risk to firm assets.[90] The likelihood of a banker serving on a board first increases and then decreases in firm volatility, a measure of risk. One potential reason is that at high levels of risk, the potential for a shareholder lawsuit increases, and courts could find the lenders serving on the board to be in control of the firm. Thus, the lenders would be liable for firm debts, or have their claims subject to equitable subordination.[91]

More generally, boards and fiduciary duties may make governance innovation more costly than optimal. We see much more governance innovation in nonpublic and noncorporate business forms. In other types of firms, including private companies, governance is more customizable. To venture capital firms, private equity firms, and investors in private firms, the difference between being an owner and a lender is semantic. Investors seek a bundle of control rights tailored to the needs of the firm, the market conditions, and the legal regime. What these are called is unimportant. The decision instead is driven by the relative transaction costs involved. If tailored governance is observed in these firms and not in public firms, this may suggest optimal sorting—that is, the firms that need specialized governance are private and those that do not are public. But since we observe public firms going private, in part driven by gov-

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nounced in the case were framed in general terms, and nothing about the court's language suggested that it was intended to be offhand dicta or a rule of limited application.

88. *See* Kroszner & Strahan, *supra* note 32.

89. *Id.* at 417.

90. *Id.* at 418.

91. Even in the private context, investors have been put in a precarious position as a result of having a seat on a board. *See Trados* discussion *supra* Part IV.A; Bartlett, *supra* note 60.

ernance issues, we can safely conclude that there is a suboptimal level of governance innovation in public firms. This is because it is extremely expensive and risky to take a firm private, and in our current system, there is no option for separating governance from control.

C. Identifying External Governance

To be clear, we are not saying that everything happens by contract or transaction external to the firm. While some scholars define the corporation or a firm as a thing in itself, others have suggested that it is more appropriate to view it as a collection of stakeholder interests.[92] Several strands of literature build on that contractual view of firms. Thus, a growing number of scholars now examine creditor control,[93] alternative views of who stakeholders are, and concepts of "post-board" firms.[94] While we start from the same observation of the market relations of stakeholders, we suggest these pure contractarian views do not get things quite right.

The error comes from the current tendency to ignore a fundamental disconnect between a Coasean theory and a contractarian view of firms. The question is not whether the firm is a siloed entity or a nexus of contracts. The better question is the Coasean one: what decisions are being produced within the firm (at the ultimate direction of the hierarch), and what decisions are being produced outside the firm. Just as the shareholder-centric literature errs when it assumes shareholders are making all decisions for a firm and the board-centric literature errs when it assumes the board is making all the decisions, the contractarian literature errs by suggesting that market contracts control all decisions.[95] Equating a covenant in a credit facility with a board's or CEO's direction for a firm to undertake a new marketing campaign is to ignore Coase's fundamental insight about the boundaries of firms altogether. While these two things may reduce to contractual sources if we abstract enough, one cannot seriously maintain that a contract with an outsider and a directive from a

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92. *See* sources cited *supra* note 2.

93. *See* Baird & Rasmussen, *supra* note 10; Tung, *supra* note 10.

94. Kelli Alces coined this term to describe a firm that collects the interests of its shareholders and can function without a board. In one version, she proposes a firm run by an investors committee. In an extreme version, the firm is run entirely by the contracts that make it up. *See* Alces, *Beyond the Board*, *supra* note 2.

95. It is here that our analysis differs from that of Gulati, Klein, and Zolt. *See supra* note 35. Where they present a model that describes everything the firm does in contractual terms, we suggest a bifurcated analysis of the production function of the firm and the production of governance.

manager are the same thing.[96] The reality is that market governance is more organic and does not arise from a hierarchy, a team, or any hub-and-spoke set of relationships. Tweaking one contract or relationship can have incidental effects that are not as predictable or direct as the hub-and-spoke metaphor suggests. Again, the Chrysler bankruptcy provides an extreme but demonstratively useful example. The Government's decision to give TARP funds to large banks changed the relationship those banks had with other investors who were party to the Chrysler credit facility. That dramatically changed the governance decisions and litigation in the Chrysler bankruptcy even though it involved no transaction involving Chrysler directly.

D. Rethinking Takeover Defenses

Finally, our analysis of the realities of modern corporate governance departs radically from the takeover literature of the 1980s, which viewed control as produced by firms (through boards and managers) and generally housed within a single firm.[97] The insight from scholars observing the takeover craze of that era was the simple point that sometimes the market could do better. Because governance was entirely inside a firm and run through the board, the market provider had to gain control of the board to improve governance. In that way, hostile takeovers and proxy contests provided the full market mechanism.[98]

But the "control" being transferred there is only a slice of the larger governance picture. One cannot often really *take over* a firm just by en-

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96. This point focuses our attention on a fundamental challenge in the theory of the firm literature. Analysis often devolves to a question of defining terms. We can say that firms are just extremely entrenched or long-term contracts. But then the question becomes why parties enter such contracts. Coase was acutely aware of this. Coase, *supra* note 1, at n.21. The relevant question is not what word we use to describe the difference between the covenant and the manager's directive. The relevant question is why debt-to-equity ratios are determined by the former and marketing campaigns are determined by the latter. *Cf.* Casey & Sawicki, *Copyright in Teams*, 80 U. CHI. L. REV. 1683, 1687 n.16 (2013) ("It is unimportant that that relationship may nominally be created by a long-term contract. The outcome is the same, and the difference is semantic. Importantly, we are distinguishing hierarchical production from outright market purchase that occurs after a good is produced. There are, of course, grey areas between those extremes.").

97. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE. L.J. 698, 737 (1982).

98. Incidentally, it also made for a great *deus ex machina* in films about big business. For example, the resolutions of such varied films as BATMAN BEGINS (Legendary Pictures 2005) and DODGEBALL: A TRUE UNDERDOG STORY (Red Hour Films 2004) rely heavily on a clean (though improbable) transfer of control through this hostile takeover market. Indeed, in the underappreciated '80s classic, THE SECRET OF MY SUCCESS (Rastar 1987), Michael J. Fox wraps up the entire film in a five-minute board meeting by announcing a hostile (but benevolent) takeover. The film then fades out to the tune of Pat Benatar singing, "Sometimes the Good Guys Finish First."

gaging in a "takeover" (that is, buying a majority of shares). Loans will generally have to be refinanced or lender approval acquired. "Poison puts" may make it impossible to even change a slate of directors without lender consent.[99] And sometimes even lender approval will often not be enough.

Consider again the Chrysler bankruptcy. Putting aside the doctrinal questions of legality of the sale of Chrysler, one thing is plain from the case: the combination of consenting stakeholders necessary to sell control was staggering. The private lenders had to agree among themselves. The managers had to consent to and propose a plan. Most people assume that the United States government had to approve any deal (both in its role as a senior lender and as a political entity).[100] The Canadian government also had to be on board.[101] And most controversially, the unions had to go along. Indeed, the strongest defense of the bankruptcy sale in Chrysler—which transferred immense value from creditors to unions—was that as a practical matter, the unions had to be appeased if Chrysler was to be sold as a going concern that made cars in the United States.[102]

This is today's takeover market. It is massive and complicated and involves a lot more than poison pills and hostile tenders for shares. Because the control is produced in a market and is not centralized in a firm, transfers can be complicated and often require judicial intervention—even for solvent firms.

The Texas Rangers bankruptcy provides another plain example of this.[103] The Rangers firm was poorly managed, and its corporate parent was insolvent. All parties agreed that it needed to be sold. But the team itself (housed in a separate legal entity) was easily worth more than its liabilities. So why did the Rangers file for bankruptcy?

The Commissioner of Baseball and JPMorgan Chase (the senior lender to the parent company) both had contractual rights to approve or veto any sale of the team but disagreed on who it should be sold to. The Commissioner seemed only willing to approve a sale to a purchaser run by Nolan Ryan. JPMorgan Chase claimed that the sale to Ryan was a

99. The enforceability of these may not be ironclad, but that goes to our point about the law hindering the market.

100. We will not even start to delve into the internal workings necessary to get an official position from the government.

101. Roe & Skeel, *supra* note 51, at 733 n.11 (citing Affidavit of Ronald E. Kolka in Support of First Day Pleadings ¶¶ 92, 108, *In re* Chrysler LLC (Chrysler I), 405 B.R. 84 (Bankr. S.D.N.Y. 2009) (No. 09 B 50002 (AJG)), 2009 WL 1266134.

102. *See* Baird, *supra* note 52. We have not even touched on the control rights that the Supreme Court of the United States may have declined to exercise there. *See* Ind. State Police Pension Trust v. Chrysler LLC, 558 U.S. 1087 (2009).

103. *See In re* Texas Rangers Baseball Partners, 434 B.R. 393 (Bankr. N.D. Tex. 2010).

sweetheart deal, with no market test, that transferred value from JPMorgan Chase to one of Baseball's favored sons.[104] That may have been true, or JPMorgan Chase may have been attempting a classic opportunistic hold up.[105]

The contracts were silent on what to do when JPMorgan Chase and the Commissioner had created a stalemate preventing a sale with their dueling veto powers. The court had to fill the gaps of the incomplete contract. The court essentially split the difference and nullified JPMorgan Chase's veto right but forced a market test for the sale to Nolan Ryan's firm.[106] The court noted that JPMorgan Chase might retain a right to sue for damages for breach of the veto right, but those damages were certain to be zero in the eyes of the court that approved the sale as part of an auction it helped design.[107]

In all of this, the board was irrelevant. It was not even clear who the board was once JPMorgan Chase pushed the parent company into involuntary bankruptcy and claimed that it controlled the equity in the team. The court punted on that question and appointed a restructuring officer to manage the Rangers in bankruptcy.[108] Governance of the Rangers was thus in the hands of a bank, the Commissioner of Baseball, a court (or many possible courts, both trial and appellate), as well as various other stakeholders, including players,[109] fans, the media, and other baseball teams.

This suggests a new model of takeover defenses. If today's takeovers look increasingly like the situation in Chrysler (with or without such a central role for Uncle Sam), then the conventional stories become less relevant. We have no quibble with the idea that the market for corporate governance would be efficient, but merely point out that this theory may

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104. Brief in Opposition Filed by Ad Hoc Group of First Lien Lenders, GSP Finance LLC, as Successor in Interest to Barclays Bank PLC, as Administrative Agent and Collateral Agent to the Second Lien Lenders, JP Morgan Chase, at 3–15, *In re* Texas Baseball Partners, 434 B.R. 393 (Bankr. N.D. Tex. 2010) (No. 10-43400).

105. *See In re Texas Rangers Baseball Partners*, 434 B.R. 393.

106. *Id.*

107. Mark Cuban's bids provided the market test that ultimately drove Ryan's bid up by tens of millions of dollars. *Id.*

108. Incidentally, the restructuring officer, William Snyder, was not particularly popular for his interference in the high-stakes game of chicken among the parties: "[M]any parties to the dramatic and prolonged transaction could agree on one thing, at least: the full-bore loathing they had for one William K. Snyder." Barry Schlacter, *Why People Love to Hate Bankruptcy Guru William Snyder*, D MAGAZINE (Mar. 2011), *available at* http://www.dmagazine.com/publications/d-ceo/2011/march/why-people-love-to-hate-bankruptcy-guru-william-snyder.

109. The largest unsecured creditor in the case was Alex Rodriguez.

falter as a descriptive and normative matter when you define the market so narrowly as to just include equity.

Once the market for governance expands, as we think it should, to include more and more places where governance is actually exercised, and to include more mechanisms through which it is exercised, takeover defenses have to be rethought. The takeaway may well be that poison pills and their ilk are part of the market, not obstacles to it. It is wrong to think that the directors' only goal is to maximize value to shareholders. They may have many contractual and norm-based obligations elsewhere. And if the control were to be efficiently bought it would include the rights to remove those directors and poison pills. It is naïve to think that we can just put our thumb on one activity taken by market players and say that we make the market more efficient by preventing that activity when we do not even know what the market is and how broad it is.

One might respond to our claim in general or in the context of takeovers that the choices about governance are in some ways forced upon the founding entrepreneur, who had control and only gives it up by choosing to enter into a market relationship. But this does not change the analysis. Just as GM might spin off the division that makes engines (or find an outside supplier), an entrepreneur decides which parts of control will be produced internally and which will be produced in the market. Of course, the entrepreneur has some of the choice thrust upon him. A major auto manufacturer has no choice but to hire autoworkers and follow government regulations. But they do have some say in how other structures are configured. Once the control has been put out in the market, it is more difficult to restructure. The control rights would have to be reintegrated. That is what makes the market for corporate governance more complicated than the takeover literature of the 1980s suggests.

V. CONCLUSION

Our modest goal in this Essay is to suggest an alternative to the board-centric model of analyzing corporate governance. There is no team with a coach, only corporate governance players. Instead of a rigid hierarchical system of corporate governance, we describe something more akin to a nimble, shape-shifting organism. It is important that we understand the real sources of power in modern firms, as well as the potential that could be unlocked by freeing markets to provide a greater suite of governance options for firms. This Essay is a first step toward understanding barriers to innovation that exist in current law.

With the foundational understanding that firms are run not by shareholders but by multiple stakeholders in complex relationships, it is time to dig deeper into how those relationships are structured—to identify where stakeholders are parts of teams and where they sit on the outside—and how those characteristics effect the economic operation of the firm. It is our ultimate goal to identify a more systematic framework for doing so.