Team Production Theory and Private Company Boards

Elizabeth Pollman*

INTRODUCTION

What is a corporation? Who owns it? Why do corporations have a board of directors, and what is its role? These time-enduring questions, and their variations, have provided the frame on which corporate law scholarship has been built and rebuilt over time.

As the story goes, by the late 1990s, the principal–agent view of the corporation had come to dominate corporate law scholarship. This model views public corporations as assets owned by shareholders (principals) who hire directors and officers (agents) to manage the assets on their behalf.1 Corporate law, in this model, is understood as a solution to the agency-cost problem that arises from the diverging interests of principals and agents, and the primary goal of the corporation is understood to be maximizing shareholder wealth.

In their path-breaking article, A Team Production Theory of Corporate Law, Professors Margaret Blair and Lynn Stout showed that alternative economic problems also provide insight into the nature and function of the public corporation and corporate law.2 Their focus was on team production—which they describe as situations where two or more individuals or groups are making team-specific inputs of investment and effort—and the gains from such team production are nonseparable.3 Team

---

* Associate Professor of Law, Loyola Law School, Los Angeles. This Essay was prepared for the Berle VI Symposium held at Seattle University School of Law. Thanks to Chuck O’Kelley, the Adolf A. Berle, Jr. Center on Corporations, Law and Society, and the Seattle University Law Review. Thanks also to symposium participants, Afra Afsharipour, Brian Broughman, and Michael Guttenberg for helpful comments on an earlier draft.


2. See Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 VA. L. REV. 247 (1999) [hereinafter Blair & Stout, Team Production].

production can give rise to problems in determining how to divide economic surpluses generated by the team. Agreements made ex ante about how to divide the surpluses, before they are generated, invite shirking, whereas ex post divisions create incentives for opportunistic, rent-seeking behavior.4

Blair and Stout argued that the “otherwise puzzling arrangement” of the board of directors in a corporation can be understood as a solution to this team production problem.5 That is, a public corporation is “a nexus of team-specific assets invested by shareholders, managers, employees, and others who hope to profit from team production.”6 Team members who cannot easily contract with each other over how to divide the gains of team production agree to leave that decision, and control over the corporate assets, to the board of directors.7 Thus, according to Blair and Stout, the corporation, a legal entity, holds the assets and the board of directors serves as a “mediating hierarchy,” or trustee, for the firm as a whole.8 This mediating hierarchy encourages firm-specific investments from team members and helps to reduce the shirking and opportunistic behavior that would otherwise arise if the team members divided the surpluses themselves.9 Further, the authors presented the mediating hierarchy model of the public corporation as providing theoretical support for arguments against the shareholder wealth maximization norm and an understanding of shareholders as owners.10

While Blair and Stout provided a dramatically different view of the corporation from the conventional principal–agent account, they also delineated limitations to their proposed theory. Most importantly, they noted that the mediating hierarchy model “applies primarily to public—not private—corporations.”11 They explained this caveat by contrasting the widely dispersed share ownership of public corporations, which frees directors from the control of the shareholders, executives, and employees, with the concentrated stock ownership of private corporations.12 In private corporations, “stock ownership is usually concentrated in the hands of a small number of investors who not only select and exercise tight

4. Blair & Stout, Team Production, supra note 2, at 249.
6. Id.
7. Id.
8. Id.
9. Id.
10. Id.
11. Blair & Stout, Team Production, supra note 2, at 281.
12. Id.
control over the board, but also are themselves involved in managing the firm as officers and directors. 13

This Essay, prepared for the Berle VI Symposium, takes the stated limitations of Blair and Stout’s work as a starting point and examines whether the team production theory, particularly the mediating hierarchy model of the board of directors, is indeed inapplicable to private corporations. After describing the boards of both startup corporations and other private corporations, this Essay explores how the public–private line of the model’s stated applicability is not as clear or impermeable as originally suggested. The mediating hierarchy model is reflected in certain private corporations and might in fact find some of its clearest expression in the evolution of startup companies. 14 The main contribution of this Essay is thus to show that Blair and Stout’s theory need not be limited to public corporations. While the board of directors does not act as a mediating hierarchy in all corporations, this Essay shows that the board can solve a team production problem in private as well as public corporations.

The Essay proceeds as follows. Part I discusses Blair and Stout’s team production theory of corporate law, with its mediating hierarchy model, and their caveat that it is a theory of public—not private—corporations. Part II provides an overview of private company boards of directors. Part III analyzes the following ways in which the team production theory and mediating hierarchy model fits, as a descriptive matter, with certain private company boards of directors: the “hiring” of the board, the use of independent directors, and the mediating role. Further, Part III examines why some, but not all, private corporations reflect the mediating hierarchy model.

13. Id.

14. Conversely, for an argument that “in a large number of U.S. corporations, boards of directors do not function as truly autonomous ‘outsiders,’ capable of mediating disputes between managers and other corporate constituencies,” see John C. Coates IV, Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?, 24 J. CORP. L. 837, 864 (1999). Further exploration of how some public company boards may not act as disinterested mediating hierarchies could also prove valuable in understanding the limits of Blair and Stout’s team production theory and mediating hierarchy model. For example, public corporations with a dual class share voting structure, such as Google and Facebook, allow for founders and insiders to maintain control of the board of directors even though they may no longer own a majority of the corporation’s stock. See, e.g., Stephen I. Glover & Aarthy S. Thamodaran, Debating the Pros and Cons of Dual Class Capital Structures, 27 INSIGHTS, no. 3, Mar. 2013, at 10, available at http://www.gibsondunn.com/publications/Documents/GloverThamodaran-DualClassCapitalStructures.pdf.
I. THE TEAM PRODUCTION THEORY OF CORPORATE LAW AND ITS STATED LIMITATIONS

Blair and Stout’s theory of corporate law starts with the team production problem and their observation that we can understand the corporate board of directors as a solution to this problem.\(^\text{15}\) To better understand their theory and stated limitations, it is useful to briefly review the foundations of their analysis.

Returning to the original literature Blair and Stout traced, we start with Armen Alchian and Harold Demsetz, who defined team production as production in which: “1) several types of resources are used . . . 2) the product is not a sum of separable outputs of each cooperating resource . . . [and] 3) not all resources used in team production belong to one person.”\(^\text{16}\) We can imagine as an example of team production, a group of researchers who each make a different, nonseparable contribution in developing a new drug.\(^\text{17}\) Alchian and Demsetz pointed out that team production poses contracting difficulties because, if team members agree on a specific profit allocation in advance, they may shirk, and if they agree to allocate profits after production, they may engage in wasteful rent-seeking and opportunistic behavior.\(^\text{18}\) Alchian and Demsetz argued that one solution is to create a hierarchy in which one person inhabits the role of monitor, receiving the residual profits and making sure that no one shirks, while all other team members become employees who are paid a fixed wage.\(^\text{19}\) In this model, the employees have no incentive to engage in rent-seeking behavior because they are paid fixed wages, and the monitor has an incentive to prevent shirking because the monitor receives the residual profits.

Other scholars developed and refined Alchian and Demsetz’s work on the team production problem. Bengt Holmstrom showed that a contract for team production cannot be written that both prevents shirking and allocates all of the joint output to the team members.\(^\text{20}\) He suggested that one solution to this contracting problem is to agree that an outsider, without control rights, will “break the budget” by absorbing any surplus not distributed to the team members.\(^\text{21}\) He argued that his model provided a rationale for the separation of ownership and labor in firms, as the

\(^\text{15}\) Blair & Stout, Team Production, supra note 2, at 257–58.
\(^\text{16}\) Alchian & Demsetz, supra note 3, at 779.
\(^\text{17}\) Blair & Stout, Team Production, supra note 2, at 265.
\(^\text{18}\) Alchian & Demsetz, supra note 3, at 779–81.
\(^\text{19}\) Id. at 781.
\(^\text{20}\) See Bengt Holmström, Moral Hazard in Teams, 13 BELL J. ECON. 324 (1982).
\(^\text{21}\) Id. at 325.
shareholders could be understood as the outside budget breakers and the executives and employees as the team members. Subsequently, Raghuram Rajan and Luigi Zingales modeled the team production problem with the additional specification that team members are making a firm-specific investment—a commitment of resources that is specific to that particular firm or that cannot be revoked once committed. Rajan and Zingales recognized that to incentivize team members to make such a firm-specific investment, it would be important to allow them to share in the surplus generated and to assure them that shirking and rent-seeking would be controlled. They suggested that the team members might therefore realize that it is in their own best interests to give up control rights to a hierarch that could control shirking and rent-seeking among team members and would be awarded a nominal share of the team’s output. Rajan and Zingales, like Holmstrom before them, interpreted their findings as a rationale for the separation of ownership from labor in a corporation.

Blair and Stout’s theory built on this work by substituting the corporation itself in the role of the budget breaker or hierarch, arguing that shareholders, executives, and employees are all team members. The corporation is the repository for the residual returns. It has a separate legal identity, and it protects and encourages firm-specific investments from several different groups who find it difficult to explicitly contract for team production. The board of directors is the internal governance structure in the corporation that embodies this solution—corporate law requires that a board of directors be given authority to make decisions for the corporation. Blair and Stout argued the board could be characterized as a “mediating hierarchy” because an important function of the board is “encouraging firm-specific investment in team production by mediating disputes among team members about the allocation of duties and rewards.”

After setting out this view of the corporation, which they termed the “mediating hierarchy model,” Blair and Stout explicitly limited the scope of its descriptive power. They provided the caveat that “the model ap-

22. Id. at 325, 338–39.
24. Id. at 422–24.
25. Id.
26. Blair & Stout, Team Production, supra note 2, at 269.
27. Id. at 275.
28. Id. at 278.
29. Id. at 281.
plies primarily to public—not private—corporations.” This limitation was, naturally, not itself the focus of their groundbreaking article, so they did not fully explore it. Rather, the limitation seemed to stem from the authors’ intuition that the wide dispersion of stock ownership in public corporations is what makes the mediating hierarchy model fit as a descriptive matter, in contrast with the concentrated stock ownership of private corporations in which the small number of investors have control over the board and manage the firm.

The Blair and Stout article also briefly situates team production theory in the life cycle of the corporation, stating “that the choice to ‘go public’ may be driven in part by team production considerations.” The authors illustrate this point by noting that when an individual or a small group of people starts a business, they typically prefer to keep the company private, but in time, when they seek outside investors or professional managers, “the original entrepreneurs may conclude that it is in their best interest to opt into the mediating hierarchy model by going public.” And, further, the authors assert that “an independent board is what makes a public corporation a public corporation.”

While the Blair and Stout article situates team production theory and the mediating hierarchy model on the public side, it also refers to private and closely held corporations as “alternative” or “other” organizational forms. The article thus paints a picture of public and private corporations as situated not so much on a spectrum, but rather as different business forms, with private corporations choosing to become public once they need a mediating hierarchy model because of outside investment or management.

30. Id.
31. Id.; cf. Usha Rodrigues, A Conflict Primacy Model of the Public Board, 2013 U. ILL. L. REV. 1051, 1055 (2013) (“I pause to note that I confine my remarks to public companies only, and to those without a dominant shareholder. The private firm is a horse of a different color. It often has few independent directors, and frequently large shareholders serve both as board members and executives.”).
32. Blair & Stout, Team Production, supra note 2, at 281.
33. Id. (“In other words, rational entrepreneurs prefer doing business as a private firm when team production inefficiencies are less of a problem, either because one individual’s or group’s firm-specific investment is more critical to the enterprise’s success than any other’s, or because there are relatively few obstacles to explicit contracting over the division of any surplus.”).
34. Id. at 251; see also id. at 276 (“When disputes arise, however, they want a decisionmaking procedure in place that all believe will be fair. The solution? They form a public corporation.”).
35. Id. at 249 (referring to privately held corporations as “[o]ther organizational forms”); id. at 276 (“Yet if all the potential value of an enterprise truly emanated from the firm-specific investment of a specific individual, why would that individual need to form a public corporation to hire workers and expand production? Presumably, she could use simple employment contracts or adopt an alternative business form such as a limited partnership or closely held company.”).
Does this limitation of team production theory to public corporations make sense? In what ways do private corporation boards resemble a mediating hierarchy? These questions are useful for exploring the boundaries of the team production theory and the mediating hierarchy model, as well as more generally inquiring into the role and institutional value of centralized management in private corporations. To begin to answer these questions, we can turn to an investigation of the boards of directors of private corporations.

II. PRIVATE COMPANY BOARDS

Our inquiry into private company boards begins by more precisely pinpointing the subject of examination. The first observation to make is that the line between what corporate law scholars typically refer to as “private” and “public” corporations is drawn by federal securities laws.

A company becomes subject to the Securities Exchange Act of 1934 and its public reporting requirements by listing securities on a national securities exchange, by making a registered public offering under the Securities Act of 1933, or by triggering registration requirements under section 12(g) of the Exchange Act. The third path or trigger came about in 1964 when Congress enacted section 12(g) to mandate disclosures from companies with “sufficiently active trading markets and public interest.” Motivated by the policy goal of protecting investors, Congress used company assets and the number of shareholders of record as a proxy for determining which companies were of a sufficient size to require public status. Congress recently raised this threshold in the JOBS Act, such that a company with total assets exceeding $10 million and a class of equity security held by 2,000 or more shareholders of record must register under the Exchange Act. Thus, “private” corporations are those that have not become public by one of these three distinct paths established by federal securities laws.

---

40. For a discussion of regulatory and technological changes that have facilitated liquidity and capital formation outside of an exchange listing or public offering, see Donald C. Langevoort & Robert B. Thompson, “Publicness” in Contemporary Securities Regulation After the JOBS Act, 101
Within the realm of private corporations, there are, broadly speaking, two types, although not formally distinguished by the law: (1) “startup” corporations, founded with the goal of creating innovative products or services and a relatively quick financial pay off for the founders, employees, and investors who are typically angel investors and venture capitalists; and (2) businesses that operate through the corporate form for the various advantages that it offers, while not triggering the thresholds for becoming a publicly reporting corporation. Regarding the latter category, it is mainly composed of small corporations that often begin as family businesses, although some of the nation’s largest corporations are private corporations that do not fit the “startup” model. Notable examples of such economically large private corporations include Cargill and Koch Industries, which each have annual revenues over $100 billion and employees in the tens of thousands. Examples also include companies that have been once public but were then later taken private again, such as computer manufacturer Dell.

With this brief situating of private corporations, this section now turns to examining the role and composition of their boards of directors.

A. Startup Boards

By their nature, startup companies develop from very early stage corporations—from formation itself, to seed funding and product development, early commercialization, expansion, and then an “exit” through an acquisition, an initial public offering (IPO), or a failure of the business and liquidation. Through these stages, and as companies grow in size...
and invested capital, the board of directors will typically also grow and change in composition. 47

At corporate formation, many startup corporations choose to incorporate in Delaware, which simply requires that the board consist of one or more members. 48 Thus, the board of directors for a young startup company may simply be one founder CEO or a couple founders who decide to start the company together. 49 A few early employees may join the company and be awarded stock options for common stock as incentive compensation. 50 The corporation could exist with this structure, with a one or two person/founder board, for months or even years, particularly if its funding comes from angel investors in the form of venture debt, convertible notes, or common stock. 51 The board, at this stage, is more of a paperwork formality than a functioning governing body. As one source explains, “Lots of entrepreneurs don’t want to be hassled by a board of directors early on. The entrepreneurs want to control the company, don’t want to be responsible to a board, or don’t want to waste time communicating with board members.” 52

At a certain point, however, startup corporations need more capital to bring a product to market and grow the company. Startups then typically raise venture capital financing in the form of convertible preferred stock that comes with liquidation preferences. 53 Venture capitalists and venture capital firms (VC) are based on a model of raising funds of private equity that the VCs use for investing in startup companies. 54 The

47. Id.
48. DEL. CODE ANN. tit. 8, § 141(b) (2014).
49. See VC-BACKED COMPANY DIRECTORS WHITE PAPER, supra note 46, at 1 (“Privately held [VC-backed] boards have a very high percentage of inexperienced corporate directors. First-time entrepreneurs who become founding CEOs frequently become corporate directors even before they obtain their first institutional round of venture capital financing.”).
52. FELD & RAMSINGHANI, supra note 50, at 81 (“Often, entrepreneurs don’t build a board until they are forced to by their VCs when they raise their first financing round.”).
idea is to invest in a startup company and help it grow to the point that it
can be taken public through an IPO or sold to a larger corporation for a
significant return on the VC’s investment.55 A successful exit “then lets
the venture fund distribute the proceeds to [its] investors, raise a new
fund for future investment, and invest in the next generation of compa-
ies.”56

VC investors have strong motivation to monitor their investments
and help them grow. Entrepreneurs typically have superior information
about the startup because of the technical novelty and complexity of the
product or service, but at the same time they are often unskilled at man-
aging a growing business.57 How do VCs arrange for close monitoring
and involvement to deal with these unique problems of investing in
startups? They stage their investments58 and negotiate for control rights,
such as veto rights over certain major transactions, and for seats on the
board of directors.59

As VCs continue to negotiate for seats on the board in each round
of financing, VCs typically gain increasing voting power on the board
over time.60 From the perspective of the entrepreneur, taking on VC
money means that “it’s no longer your company—you are now working
for somebody else. If you don’t perform, you will get fired.”61

56. NAT’L VENTURE CAPITAL ASS’N, 2014 NATIONAL VENTURE CAPITAL ASSOCIATION
view=article&id=257&Itemid=103.
57. Ibrahim, Debt as VC, supra note 51, at 1192.
58. See D. Gordon Smith, Team Production in Venture Capital Investing, 24 J. CORP. L. 949
(1999).
59. Ibrahim, Debt as VC, supra note 51, at 1193; D. Gordon Smith, The Exit Structure of Ven-
60. Brian Broughman & Jesse M. Fried, Carrots and Sticks: How VCs Induce Entrepreneurial
Teams to Sell Startups, 98 CORNELL L. REV. 1319, 1329–30 (2013); Smith, Exit Structure, supra
note 59, at 327 (noting that a recent survey found that by the final stage of VC investment before an
IPO, where sole control was exercised by either the common or the preferred, control was more
often controlled by the preferred). Cf. Robert P. Bartlett, III, Venture Capital, Agency Costs, and the
False Dichotomy of the Corporation, 54 UCLA L. REV. 37, 56 n.78 (2006) (noting that “[w]hile
each of the . . . contracting techniques helps VC investors minimize agency risk, they also give rise
to the possibility that the venture capitalist may use the contract rights opportunistically.”); Ronald J.
Gilson, Engineering a Venture Capital Market: Lessons from the American Experience, 55 STAN. L.
REV. 1067, 1085 (2003) (“Reducing the agency costs of the entrepreneur’s discretion by transferring
it to the venture capital fund also transfers to the venture capitalist . . . the opportunity to use that
discretion opportunistically against the entrepreneur.”).
61. FELD & RAMSINGHANI, supra note 50, at 12; see also id. at 81 (“Often, entrepreneurs don’t
build a board until they are forced to by their VCs when they raise their first financing round.”).
The voting agreement may provide not only for a board seat or seats for the VC investors, but also for the specific allocation of board seats among representatives of the common shareholders (the management and employees), the preferred shareholders (the VC investors), and an independent director or directors either mutually appointed by the common and preferred shareholders or voted on together as a single class. There is no firm rule regarding board sizes and seat allocations, but the following are typical over the life cycle of a startup corporation that takes on VC investment. In the early stages of the corporation, the board is often composed of three to five directors total, representing one to two management seats, one to three VC seats, and zero to two independent seats. Through the later stages of the startup corporation, the board typically increases to between five to seven directors, representing one to two management seats, two to three VC seats, and two to three independent seats. As the company matures and nears a liquidity event of an IPO or acquisition, its board may consider naming a formal chairman, and establishing audit, compensation, and nominating/governance committees. The average time from VC financing to exit by an acquisition or an IPO is approximately seven and eight years, respectively.

Notably, many startup companies include independent directors on their boards, often in tiebreaking positions between the directors representing the entrepreneurs and investors. As noted above, VCs negotiate for board seats in order to monitor their investments and to play an active role in helping to grow the company. In addition, they negotiate for board seats to have voting power to further their own financial interests, particularly where they may diverge from those of the entrepreneurs. Because VCs have timing pressures due to the terms of the funds they raise, and because they hold preferred stock rather than the common

---

62. Smith, Exit Structure, supra note 59, at 325–26; Broughman & Fried, supra note 60, at 1329. Such a voting agreement overrides default statutory rules regarding shareholder voting for election of the board of directors. Id.; Feld & Ramsinghani, supra note 50, at 52.
63. VC-Backed Company Directors White Paper, supra note 46, at 10.
64. Id. at 9.
65. Id.
66. Id.; see also Feld & Ramsinghani, supra note 50, at 3, 8 (noting that venture capital-backed boards are increasingly taking on the burden of adhering to public company compliance standards and best practices to improve their prospects for optimal liquidity events).
68. Broughman & Fried, supra note 60, at 1329–30; Broughman, supra note 53, at 462.
69. Broughman, supra note 53, at 463–64; Smith, Exit Structure, supra note 59, at 318.
stock that the entrepreneurs typically hold, VCs may favor exit opportunities that the common stockholders do not. For instance, “VCs may favor a quick exit and wish to avoid risky strategies that could benefit common stockholders.” In addition, potential conflict in VC-backed firms can stem from more than diverging interests between preferred stockholders and common stockholders. Entrepreneurs may also have diverging interests because they receive private benefits from running the company that are unrelated to the company’s value (e.g., the joy of being one’s own boss), and they may be inclined to decline exits or choose exits that provide them with personal opportunities. The tension between the VCs’ financial interests and those of the entrepreneurs can play out in a variety of decisions aside from when and to whom to sell the company, such as whether to replace the CEO, how much to invest in developing a new technology, and so on.

Adding an independent director can help to settle disputes that may arise and serve as a “commitment mechanism” to force compromise before an actual conflict arises. Independent directors “are usually industry experts and other outsiders whose experience and connections are expected to add value to the enterprise.” According to one study, VCs and entrepreneurs share control of the board with independent directors holding the tiebreaking vote 61% of the time, VCs control the board 25% of the time, and entrepreneurs control the board 14% of the time.

---

70. See, e.g., In re Trados Inc. S’holder Litig., 73 A.3d 17, 48 (Del. Ch. 2013); Michael Klausner & Stephen Venuto, Liquidation Rights and Incentive Misalignment in Start-up Financing, 98 CORNELL L. REV. 1399, 1433 (2013) (analyzing “how the accumulation of liquidation rights in venture capital financings can be detrimental to firm value, both because they can create conflicting interests among investors and because they can undermine the incentives of the management team”).

71. Broughman, supra note 53, at 463; see also FELD & RAMSINGHANI, supra note 50, at 69 (“However, at some point usually around the fourth or fifth year of the fund, there starts to be a series of forces that drive pressure for exits, including the desire of most firms to raise another fund in that time period. As a result, some VCs start to pressure the companies they are investors in to sell earlier than the entrepreneurs might otherwise desire, or accept an offer at an intermediate stage from a buyer for a successful outcome, but at a price much lower than the entrepreneurs believe the company will be worth in a few years.”).


73. Smith, Exit Structure, supra note 59, at 318.

74. Id.


76. Steven N. Kaplan & Per Strömberg, Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts, 70 REV. ECON. STUD. 281, 288 (2003); see also Steven N. Kaplan, Berk A. Sensoy & Per Strömberg, Should Investors Bet on the Jockey or the Horse? Evidence from the Evolution of Firms from Early Business Plans to Public Companies, 64 J.
particular instance, however, it remains a fact-specific inquiry whether a so-called independent director is truly independent. Professors Jesse Fried and Mira Ganor have explained, “Because VCs often have considerable influence over the common shareholder representatives on the board as well as the independent directors, the percentage of startup boards effectively controlled by VCs may well be much higher than a study of financing documents would suggest.” Selecting impartial, independent directors is a common topic of discussion in the startup community.

B. Other Private Company Boards

This section now turns to examining the boards of directors of other private corporations, which is an inherently more difficult task. While there is a significant amount of literature and collected knowledge about the governance structures and practices in startup companies, that is not the case for other private corporations. The commonly referred to “startup community” is indeed actually a community of sorts—venture capital is relatively organized with well-established players and trade associations, and a great deal of startup activity has emerged, and continues to emerge, from Silicon Valley and the San Francisco Bay Area.

FIN. 75, 99–103 (2009) (At the time of IPO, the median number of VC directors is three, the median number of management directors is two, and the median number of outside directors is two.).

77. See, e.g., Fried & Ganor, supra note 75, at 988–89; Smith, Exit Structure, supra note 59, at 320 n.21; In re Trados Inc. S’holder Litig., 73 A.3d 17, 54 (Del. Ch. 2013).

78. Fried & Ganor, supra note 75, at 989.

79. See, e.g., Create A Board That Reflects the Ownership of the Company, VENTURE HACKS (Apr. 1, 2007), http://venturehacks.com/articles/board-structure (“Don’t let the investors control the board through the independent board seat . . . . The simplest solution to this dilemma is to fill the independent seat before the financing.”); Brad Feld, Expectations for Outside Board Members, FELD THOUGHTS (Apr. 1, 2014), http://www.feld.com/archives/2014/04/expectations-outside-board-members.html. Feld writes:

I generally see three types of outside board members getting recruited to a board of a VC backed company:

1. The friend of the VC . . . [;]
2. The friend of the CEO / entrepreneur . . . [;]
3. An independent director. Now, this person can be a friend of the VC, or a friend of the CEO / entrepreneur, but is an independent thinker. Or they might be someone from industry that is known to one of the investors or the entrepreneur, but is recruited specifically by the CEO to join the board . . . .

Note the emphasis on independent thinker. It doesn’t matter who the relationship originates from.

Id.
where there are clusters of talent and supporting resources. By contrast, non-startup private corporations are not a part of a meaningful community of similar organizations; what connects them is simply the choice of entity of the corporate form and their non-public status under federal securities laws. Moreover, private corporations face no public disclosure obligations. As a consequence, information about private company boards is relatively scarce.

With that caveat in mind, we can first observe that private corporations are diverse—they may represent a single shareholder owner, or a family-owned or private equity-owned business, large or small. A survey by the National Association of Corporate Directors found the following diversity of private corporations:

- 18% family-owned and managed
- 13% family-owned but not family-managed
- 22% investor-owned and managed
- 17% investor-owned but non-investor managed
- 30% other.

The boards of such private corporations likewise vary in their size and nature. They tend on the whole to be smaller and less independent than public company boards and more responsive to stakeholder request than public company peers. The boards of larger private companies tend to more closely resemble public company boards in their size and structure. But not all private corporations actually have an active, functioning board of directors. A recent survey of large private corporations averaging over $300 million in revenues found that only about 70%...

---


82. NAT’L ASS’N OF CORP. DIRS., NACD PRIVATE COMPANY GOVERNANCE SURVEY (2007).

83. NAT’L ASS’N OF CORP. DIRS., NACD 2002 STUDY ON EFFECTIVE ENTREPRENEURIAL BOARDS (2002) (finding that only 28% of private company directors were independent as compared with 66% of public company directors); see also NAT’L ASS’N OF CORP. DIRS., 2013–2014 NACD PRIVATE COMPANY GOVERNANCE SURVEY 12, 14 (noting that the average public company has 8.6 directors versus 7.6 at the average private company and that “[o]nly 33 percent of private company boards with a non-independent chairman have a lead director, compared to more than 75 percent analogous public company boards”).


85. Id. at 5 (noting that “larger private companies (those with annual revenues greater than $250 million) tend to more closely resemble public companies in areas such as board size, committee structure, and subsidiary governance”).
of the corporations surveyed had “a formal board of directors” that meets quarterly or more frequently.  

Only about one-quarter of such large private company directors are independent, outside directors. The company’s CEO serves as chair in 71% of the private company boards surveyed.

A recent survey of family-owned businesses found that 28% do not have a board of directors. Family-owned businesses that do have a board commonly report that it is dominated by family members. In fact, 60% of those surveyed responded that family members constitute a majority of their boards; “only 39% are controlled by a majority of non-family, non-executive members.” Even where such outside directors serve on boards, Professor Jennifer Johnson has pointed out that they may have close ties to the managers or a controlling shareholder:

Whatever the efficacy of independent directors as monitors of controlling shareholders in public companies, in the private arena independence as a proxy for effective monitoring is illusory. In a private company, even outside directors are ordinarily selected by the inside managers and/or the controlling shareholder. Seldom do we encounter the mediating influence of a board nominating committee in any but the very largest of the private entities. In a closely held enterprise, the stockholders often even dispense with the formality of director elections due to the predetermined outcome of the endeavor. . . . In many private companies, actions by a nominally independent director that displease the majority shareholder will generally result in the swift removal of the director from the board.


87. Id.

88. Id.

89. DELOITTE CTR. FOR CORP. GOVERNANCE, PERSPECTIVES ON FAMILY-OWNED BUSINESSES: GOVERNANCE AND SUCCESSION PLANNING 3, 19 (2013), available at http://www.corpgov.deloitte.com/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/USEng/Documents/Board%20Governance/Private%20and%20Not-for-Profit%20Organizations/Perspectives%20on%20Family%20Owned%20Businesses_Deloitte_June%202013.pdf (90% of this survey was private corporations, 10% public; 100% of respondents said the majority of the stock was owned by one or more family members of the original company founder).

90. Id. at 3. See also Frederic D. Tannenbaum, All in the Family: Governance Issues in Family-Owned Businesses, in ALI-ABA’S PRACTICE CHECKLIST MANUAL ON ADVISING BUSINESS CLIENTS III: CHECKLISTS, FORMS, AND ADVICE FROM THE PRACTICAL LAWYER 122 (2004) (noting that most family-owned businesses have boards dominated by family members and senior management, and that independent directors are rare).

91. Johnson, supra note 81, at 270.
Furthermore, the large majority of family-owned businesses have relatively static boards, with no term limits or age limit and nearly no turnover of board membership in any given year. The family plays a key role in nominating and electing board members: 81% of family businesses have some family involvement. A small but significant number of family businesses use a family council or advisory board as a supplement or replacement for a traditional board of directors.

A few examples of private company boards might help bring these statistics to life. In terms of absolute numbers, small and family-owned private companies predominate, though it can be hard to find specific examples of such companies’ board compositions. One well-known family-owned private corporation, albeit quite large, is candy maker Mars, which has a board of directors made up of Mars family members.

Dell Inc., which was recently taken private, provides an example of a private equity-backed company board. Under the company’s capital structure, CEO Michael Dell is reported to own 75% of the corporate stock and Silver Lake Management LLC owns the remaining 25%. Whereas in its public incarnation Dell had a board composed of twelve directors, nearly all of whom were independent outsiders besides Michael Dell, as a private company, Dell’s board reportedly consists of Michael Dell and two Silver Lake partners.

Cargill, Inc. provides an example of an economically large, non-startup private company. Cargill’s board is currently composed of fourteen members, reflecting a mix of insiders and outsiders. Insiders include the executive chairman, two vice-chairmen, as well as the CEO. Outsiders include directors who hold primary positions in other organizations and corporations such as U.S. Bancorp, Medcor, Inc., Target.

92. DELOITTE CTR. FOR CORP. GOVERNANCE, supra note 89, at 3, 9–10.
93. Id. at 8.
94. Id. at 3, 6–7 (19% use an advisory board; 35% “use a family council or other governing structure to align family interests with corporate interests”).
In sum, the boards of non-startup private corporations are diverse, ranging from an effectively non-existent board to a board with outside directors. On the whole, these private company boards tend to be smaller and less independent than public company boards, and even where they include outside directors, such directors may have close ties to the managers or a controlling shareholder. These private company boards provide a contrast to those of startup corporations discussed earlier in this Part, which follow a more established life cycle and evolution, often eventually including VCs and entrepreneurs on the board as well as independent directors in important tiebreaking positions.

III. EXPLORING THE APPLICABILITY OF TEAM PRODUCTION THEORY AND THE MEDIATING HIERARCHY MODEL TO PRIVATE COMPANY BOARDS

The previous Part described private company boards, highlighting the diversity of private corporations and the various roles of centralized management in such corporations over time. This Part expands on this background, exploring the applicability of team production theory and the mediating hierarchy model. Specifically, it examines the following ways that the mediating hierarchy model is reflected in some private company boards: the “hiring” or evolution of the board, the use of independent directors, and the mediating function of the board. This Part concludes that Blair and Stout’s theory need not be limited to public corporations and examines where the limits of their theory might instead lie among private corporations.

A. Ways That Private Company Boards Reflect the Mediating Hierarchy Model

1. The “Hiring” of the Board

One of the first distinguishing features of Blair and Stout’s mediating hierarchy model is that it involves the team members “hiring” the board.100 We can observe this activity in the private company world: ad-
vice from the startup community routinely trumpets the idea that the entrepreneur managers should carefully choose the board members, and therefore from which VCs to take money. For example, a partner from the prestigious VC firm Andreessen Horowitz explained: “The best board members aren’t elected by default. CEOs that set themselves up with their choice of board member—which means getting more than one term sheet and doing extensive reference checking—are better off. You want to find a coach, not a lever puller.”

Similarly, the Vice President of Advancing Innovation at the Kauffman Foundation said:

A lesson I acquired over the years is that some mentors and advisers can actually give you harmful advice. You have to be picky! Talk to other entrepreneurs who have scaled companies, talk to C-level executives who have access to the networks and experience you need. This is your company, and the decisions regarding advisers or board members is all on you—make it count.

One recent book aimed at advising startup entrepreneurs has entire chapters on the topics of “Creating Your Board” and “Recruiting Board Members.” The authors explain that creating a board of directors involves a search process: “The search for a new board member, like the search for any addition to your team, is a process. While you typically will start with people you know—other entrepreneurs, your investors, attorneys, or recruiters—to get introductions, you shouldn’t stop there.” The process for recruiting directors continues to include interviewing many people, checking references, and sometimes even having finalists attend a board meeting. Readers are implored to consider more than just the money that investors bring to the table, but also the character and experience of the people who would be joining the board:

As difficult as it may be, great entrepreneurs seek the right balance of character and capital from investors. You can compromise on the latter but never on the former. The art of proactively building your board, even as you seek to engage the best-in-class investors and integrate their capital and minds with your startup, will benefit you

factors of production. If the firm subsequently goes public, the founding entrepreneurs commonly are replaced by a more or less independent board. The board thus displaces the original promoters as the central party with whom all other corporate constituencies contract. In this sense, the board of directors—whether comprised of the founding entrepreneurs or subsequently appointed outsiders—hires factors of production, not the other way around.” (internal citation omitted)).

101. FELD & RAMSINGHANI, supra note 50, at 56.
102. Id. at 57.
103. Id. at 49, 63.
104. Id. at 57.
105. Id. at 58–59.
greatly in the long-term. While investors bring capital to the table, great board members bring capital, experience, and an emotional foundation to help the startup, the entrepreneurs, and the CEO succeed through the inevitable ups and downs of creating a company.106

Further, the importance of “hiring” the right board members is not just because their character and experience may prove valuable to the company. Hiring the right board members is also important because “in most cases, once you have them on the board, it’s difficult to get rid of them.”107 And, once the board is formed and takes on an active role, the possibility that the board might replace the CEO or other entrepreneur managers also looms on the horizon.108 Many founding entrepreneurs are indeed eventually replaced.109 One study found that at the time of IPO, 43% of CEOs are non-founders.110

This story of startup entrepreneurs taking on firm-specific investment and choosing board members who will help the company grow and succeed echoes the story of team production theory in corporate law. Blair and Stout wrote:

In this scenario, a number of individuals come together to undertake a team production project that requires all to make some form of enterprise-specific investment. Perhaps one individual brings critical technical skills to the table, while another has a talent for management, and a third provides marketing insights. They may lack financial capital, however, so they seek out wealthy friends or family members to put up initial funding. Thus, a team is born. Undertaking team production, however, requires each of the members to make irrevocable investments that leave them vulnerable to opportunistic exploitation by other team members. . . .

106. Id. at 25.
107. Id. at 31.
108. Cf. Blair & Stout, Team Production, supra note 2, at 279 (“[I]f the hierarchy so decides, dissenting team members can be forced out of the coalition and cut off from sharing in future rents.”).
110. Steven N. Kaplan et al., What Are Firms? Evolution from Birth to Public Companies 4, 21 (Ctr. for Research in Sec. Prices, Working Paper No. 603, 2005), available at http://www.aeaweb.org/assa/2006/0107_1430_0303.pdf (“Once the firm’s non-human assets are established, it seems possible (and not unusual) to find other people to run the firm.”); see also Malcolm Baker & Paul Gompers, The Determinants of Board Structure at the Initial Public Offering, 46 J.L. & ECON. 569, 569–98 (2003) (finding that the probability that a founder remains as CEO decreases as the VC’s bargaining power increases, using the VC’s reputation as a proxy for bargaining power).
Despite their mutual vulnerabilities, the team members expect for the most part to be able to get along with each other and figure out how to allocate tasks and divide up rewards as they go. When disputes arise, however, they want a decisionmaking procedure in place that all believe will be fair. The solution? They form a public corporation.\footnote{Blair & Stout, Team Production, supra note 2, at 275–76 (emphasis added).}

With the exception of the last line, this quote could be the story of a startup at the end of its seed financing, at the time when the board changes from the formality of a one or two person/founder board to a board reflective of different team-specific investments that have been made. Elsewhere, Blair and Stout argue “that hierarchs work for team members (including employees) who ‘hire’ them to control shirking and rent-seeking among team members.”\footnote{Id. at 280 (emphasis in original).} The process of entrepreneurs “creating” a board and “recruiting” board members in many ways parallels Blair and Stout’s description.

And yet, it is not necessary to “form a public corporation,” as Blair and Stout say, to form such a board of directors—this process occurs in private startup corporations once they grow past the early stage and they take significant outside investment from VCs who negotiate for board seats. Further, this process of “hiring” a hierarch does not necessarily coincide with a decision “to go public,” as it can occur without listing securities on a national securities exchange, without making a registered public offering, and without triggering registration requirements under section 12(g) of the Exchange Act, which relates to the number of shareholders of record. Indeed, with the current potential for raising money through large private placements and creating liquidity through private secondary markets,\footnote{See generally Zachary J. Gubler, Public Choice Theory and the Private Securities Market, 91 N.C. L. REV. 745 (2013) (discussing “the dramatic expansion of the unregulated market for private securities in the United States”); Pollman, supra note 40 (discussing private secondary markets); Craig M. Lewis, The Future of Capital Formation, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 2, 2014, 9:02 AM), http://blogs.law.harvard.edu/corpgov/2014/05/02/the-future-of-capital-formation/#more-62903 (“During the last calendar year, more than a trillion dollars was raised through private channels, including by operating companies, venture capital and private equity funds.”).} many private corporations prefer staying private, and are only “forced” to go public if they hit the section 12(g) threshold, which was recently raised in the JOBS Act.\footnote{Pollman, supra note 40, at 192 (discussing companies forced to go public upon hitting the section 12(g) threshold); Langevoort & Thompson, supra note 40, at 371 (“We are already at a point where the section 12(g) size requirement will seldom be a binding constraint in forcing a company in to the public status of the 1934 Act, and we may in the future find ourselves where many more com-}
In sum, the “hiring” of the board of directors occurs before the corporation goes public. It is not necessarily part of a decision to go public. Corporate law indeed requires a board of directors in all corporations, public and private. Most private startups need to take significant outside investment to grow and bring a product to market, which brings it to the stage of forming a board that acts as something more than a paperwork formality. It is in the private company context, rather than the public one, that “[p]roviders of financial capital . . . are just as ‘stuck’ in the firm as are providers of specialized human capital.”\textsuperscript{115}

What seems additionally required, however, to truly fit Blair and Stout’s model is for the board to be a “disinterested hierarch.”\textsuperscript{116} It is this aspect of the mediating hierarchy model that separates out many—but not all—private corporations.

2. The Use of Independent Directors

Blair and Stout’s model of the mediating hierarchy is “an independent board.”\textsuperscript{117} The authors do not define this term, but suggest it is a “disinterested”\textsuperscript{118} board, “many of whose members are drawn from outside the firm.”\textsuperscript{119} “Although directors have incentives to accommodate the interests of all [the] groups [that make up the corporate team], they are under the command of none.”\textsuperscript{120}

The authors’ specification of board independence, or at least inclusion of many outsiders,\textsuperscript{121} is a key reason why the mediating hierarchy model does not apply to many private company boards. As discussed above, many family-owned and private-equity backed corporations have effectively non-existent boards or boards that consist of directors who are large or controlling shareholders as well as managers of the corpora-

\textsuperscript{115} Blair & Stout, Team Production, supra note 2, at 277.
\textsuperscript{116} Id. at 284.
\textsuperscript{117} Id. at 251.
\textsuperscript{118} Id. at 284.
\textsuperscript{119} Id. at 252; see also id. at 276 (“This board may include several team members or their representatives, but it may also include (and in public corporations almost invariably does) several outsiders.”).
\textsuperscript{120} Id. at 281.
\textsuperscript{121} Professors Blair and Stout do not state a specific proportion of outsiders required to constitute an “independent board” by their terms. For an argument that a mix of insiders and outsiders might be the optimal board structure, see generally Donald C. Langevoort, The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequence of Independence and Accountability, 89 GEO. L.J. 797 (2001); Sanjai Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 BUS. LAW. 921 (1999).
Such directors cannot be said to be free from control of the groups that make up the corporate team.

However, some private corporations have a significant number of outside directors and there is reason to believe they function in an independent manner. For instance, the Cargill board example reflects a board with a majority of outsiders who hold positions in respected organizations from a variety of industries. As these boards are subject to no legal requirement or exchange rule to have independent directors on the board, they arguably reflect a mediating hierarchy as much as the principal–agent model.

But even if one were to discount such examples as being relatively few in number, or such directors as being heavily influenced by the concentrated shareholders who elect them to the board, there are still a significant number of private corporations that have independent directors: startups. Once we take account of the life cycle of startup corporations, we observe that when startups get beyond the seed financing stage and take on outside investment, they commonly add outside independent directors.

As discussed above, one study has shown that 61% of the time VCs and entrepreneurs share control of the board with independent directors who hold the tie-breaking vote. Furthermore, the allocation of board seats over time, from the first venture capital financing to the IPO, often maintains the independent director or directors in an important, tie-

122. See, e.g., William S. Hanneman, The Case for Independence in Private Company Boards, ZACHERY SCOTT INV. BANKERS (2005), http://www.zacharyscott.com/insight/management/private-company-boards.aspx (“Having worked with hundreds of private, family-owned businesses over the years, we have found that the vast majority does not maintain active boards of directors or advisory boards that could be legitimately considered as independent.”).

123. See, e.g., Carl Kampel, Why Privately Held and Family-Owned Businesses Should Have Independent Boards of Directors, FIN. EXEC. (Nov. 2012), http://www.financialexecutives.org/KenticoCMS/Financial-Executive-Magazine/2012_11/Why-Privately-Held-and-Family-Owned-Businesses-Sho.aspx#axzz2bhCaFTVn (“There are clear examples of very profitable privately held or family-owned businesses—with no debt to lenders or outside investors—that have independent boards of directors.”).

124. See supra text accompanying notes 98 & 99; see also Caroline Daniel, Chateau Cargill Opens Its Hallowed Halls, FIN. TIMES (Feb. 25, 2004), http://www.iatp.org/news/chateau-cargill-opens-its-hallowed-halls (discussing Cargill’s transition in the 1990s to a model with non-family managers and a board consisting, at the time, of “17 members: six family, six independents, and five management appointees”).

125. Kaplan & Stromberg, supra note 76, at 288; see also Boone et al., The Determinants of Corporate Board Size and Composition: An Empirical Analysis, 85 J. FIN. ECON. 66, 90 (2007) (examining corporate boards post-IPO and finding that venture capital financing “has the largest impact on board independence”); Yael Hochberg, Venture Capital and Corporate Governance in the Newly Public Firm, 16 REV. FIN. 429, 429–480 (2012) (finding that the boards of directors of VC-backed companies are more independent than those of similar non-VC-backed companies).
breaking position so that neither the entrepreneurs/founders nor VCs control the board:

The median board size is 5 seats at the business plan, 7 seats at the IPO, and 7 at the annual report. Insiders, defined as founders and current or past company managers, hold a constant median of 2 seats at each of the business plan, IPO, and annual report. VCs hold a median of 2 seats at the business plan, 3 at the IPO, and 1 at the annual report. This pattern reflects additional VC investment between the business plan and IPO, and profit-taking once the company has issued shares to the public. Meanwhile, the board presence of non-VC outsiders, who are generally either industry experts and/or experienced executives of other firms, increases from a median of 1 seat at the business plan to 2 at the IPO to 3 at the annual report.\(^{126}\)

Numerous sources from the startup community support using independent directors as boards evolve. For example, notable VC Fred Wilson discussed the evolution of the Twitter board:

Boards should evolve. . . . [A good] example is Twitter, where I was the first outside director, taking a board seat when Twitter was formed in the spinout from Obvious and [when] USV made its initial investment. Over time Twitter added several investor directors and then started adding independent directors. By last fall, Twitter had the opportunity to create a board with two founders, a CEO, three independent directors, and one investor director.\(^{127}\)

Similarly, an Andreessen Horowitz partner, Scott Weiss, explained:

---


I’m a firm believer that neither the founders nor the VCs should have control of the board. My rule of thumb is that with every VC on the board, you should add an external, independent board member. Often, founders get excited about some crazy idea that makes no sense and want to pivot the whole company around that idea. And VCs have various financial pressures. The founder who has never been in business before and a VC who is stereotypical each could be wrong. I counsel entrepreneurs to seek an independent voice on [the] board.128

The Kauffman Foundation has published similar advice from Suren Dutia:

Take special care with the composition of the board so that it includes individuals other than just the founders/CEO and major investors. This means having independent directors with no conflicts of interest, who can provide balanced and independent judgment, and who can protect the interests of all shareholders. When the Series A round for capital infusion is under way and the term sheet is being negotiated, it would be judicious to discuss with investors the board structure and rationale for having a specific number of outside directors. If the startup board has five members, I would recommend that at least one or two be outside or independent directors. In case of a seven-member board, it would be desirable to have two or three independent directors.129

Why do we see such widespread use and support for independent directors on private company boards? Professor Brian Broughman has pointed out that while independent directors are often explained as serving a monitoring role in public companies with dispersed share ownership, such an explanation does not make sense for startups because VCs are typically represented on the board and can directly monitor their investment.130 With this observation, Professor Broughman theorized that startups use independent directors to balance competing interests “when

128. Feld & Ramsinghani, supra note 50, at 35.
129. Suren G. Dutia, Primer for Building an Effective Board for Growing Startup Companies 4 (2014), available at http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2014/05/primer_for_building_an_effective_board.pdf; see also Eran Laniado, 5 Huge Mistakes Startups Make When Choosing Board Members, VENTURE BEAT (Feb. 10, 2013), http://venturebeat.com/2013/02/10/5-huge-mistakes-startups-make-when-choosing-board-members/ (noting a startup should “[a]ppoint at least one independent director, loyal to the company only”).
130. Broughman, supra note 53, at 498–500. He also noted that independence, in the context of a startup company board, refers to independence from the entrepreneurs and VCs, whereas in the public context independence refers to independence from management but not necessarily shareholders. Id.
the owner and manager are not the same party or when there is heterogeneity among the group of owners (both of which occur in venture capital). To support this argument, which he characterized as “a partial extension of Blair and Stout’s theory” to VC-backed firms, he modeled a VC financing contract and showed that allocating a tie-breaking vote to an independent director can prevent opportunistic behavior that would result from entrepreneur or VC control. The parties are effectively ceding some control in order to enable the board to serve as a mediating hierarchy for the team.

These studies and pieces of expert advice show that an independent board is not “what makes a public corporation a public corporation,” as it is not unique to public corporations. VC-backed private companies often develop a level of independence on the board as the company matures. The evolution of private company boards might in fact be one of the clearest illustrations of Blair and Stout’s mediating hierarchy model coming to life.

3. The Mediating Function

This Essay has shown that Blair and Stout’s story of “hiring” the board is reflected in many private corporations and that some of these private corporations—particularly startups that have evolved past the early seed stage—often have independent directors who serve an important role in preventing opportunistic behavior from members of the corporate team. One might wonder whether corporate participants actually understand the board as playing such a dispute resolution or mediating role as “an internal ‘court of appeals’ to resolve disputes that may arise among the team members.”

131. Id. at 501.
132. Id. at 471–91 (arguing that the use of independent directors in startup firms is to “arbitrate” disputes between entrepreneurs and investors); see also Robert P. Bartlett, III, Venture Capital, Agency Costs, and the False Dichotomy of the Corporation, 54 UCLA L. REV. 37 (2006) (arguing public and private firms often face the same agency problems, both inter-stakeholder and intra-stakeholder conflicts).
133. Blair & Stout, Team Production, supra note 2, at 251.
134. See Malcolm Baker & Paul A. Gompers, The Determinants of Board Structure at the Initial Public Offering, 46 J.L. & ECON. 569 (2003) (finding that VC-backed firms have more independent outside directors at IPO than other firms at IPO).
135. Blair and Stout refer to the “mediating” role of the board of directors as one of resolving disputes among team members, making decisions about the division of duties and rewards, and having authority to do so under corporate law. In effect, the internal governance structure of the board provides a mechanism for settling disputes among corporate participants. By contrast, definitions of mediation in dispute resolution literature, whether in a facilitative or evaluative model, generally describe a mediator who lacks authority to impose a decision on the parties but who assists disputants in resolving their disagreement. See, e.g., Leonard L. Riskin, Mediation and Lawyers, 43
Sources written by experts in the startup community indeed describe a board dynamic that fits the “mediating hierarchy” model that Blair and Stout espouse. For instance, two authors with investment and entrepreneurial experience explain:

As a startup grows, the number of stakeholders increases. . . . Soon, you have a number of differing interests, some short term and some long term, related to the company. At times, these interests conflict with each other. The board ultimately is responsible for navigating any conflicts that arise.137

A former founder and serial startup CEO who now serves as an independent board member describes the role as mediating in nature:

Finally, there’s the huge benefit of constructive mediation. Too often, there are different and conflicting interests around the boardroom table. A good independent director can and should be a powerful force for mediation, brokering compromises between shareholder groups, and resolving the different views between management and the board that inevitably occur. The result is a board that can make progress without acrimony.138

Another aspect of this mediating role is often expressed in the startup context in terms of the directors needing to act in the interest of the corporation, representing all shareholders. For instance, one VC partner explained, “I have a test I use. Can I explain my decision as reasonable and fair to any shareholder group, not just my own?”139 Such an awareness of the conflict faced by directors is common because of the

136. Blair & Stout, Team Production, supra note 2, at 276–79. Cf. STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 64 (2008) (characterizing Blair and Stout’s description of the board’s dispute resolution function as inconsistent with the literature, which typically identifies the functions of public company boards as monitoring and disciplining top management, high-level strategy and policy making, and providing access to a network of contacts that may be useful to the business).

137. FELD & RAMSINGHANI, supra note 50, at 11.


139. FELD & RAMSINGHANI, supra note 50, at 12–13 (quoting August Capital partner Andy Rappaport).
known tension between preferred and common shareholders and among VC investors: “As a board member, a venture capitalist (VC) needs to act in the interest of the company, representing all shareholders, rather than their narrow interest as an investor.” As another VC partner put it, “As long as you are a board member, you have to focus on what is best for all shareholders. This can be difficult for VCs. Afterwards, you can go home and fret all you want about your fund not making a better return.”

Notably, this concern is often expressed as a duty to represent all shareholders, not all stakeholders—in this respect the understanding of the board’s role diverges from Blair and Stout’s account. In the startup context, however, shareholders and stakeholders are largely overlapping groups because founders and employees are typically granted restricted stock or options for common stock, VC investors hold preferred stock, and suppliers, lenders, and other creditors sometimes hold equity interests or warrants for stock.

Furthermore, the fact that private company stock is not publicly traded may also give the board some breathing room to serve this mediating function. Reduced pressure to achieve quarterly earnings may allow the board to make trade-offs that enhance long-term firm value. In addition, reputational considerations may also encourage directors to take multiple stakeholders’ interests into account, as many VCs and en-

140. Id. at 12.
141. Id. at 14 (quoting True Ventures managing partner Jon Callaghan).
142. See NAT’L ASS’N OF CORP. DIRS., 2013–2014 NACD PRIVATE COMPANY GOVERNANCE SURVEY (2013) (“Private companies are not held to the same level of regulatory and investor scrutiny as public companies, which can be an advantage for their directors.”); JOHN L. WARD, CREATING EFFECTIVE BOARDS FOR PRIVATE ENTERPRISES 77 (1991) (“Private company boards, free from some of the pressures and obligations that burden public company directors, are able to fulfill some special opportunities to help improve corporate performance and decision making.”). Whether investors engage in short-termism that harms markets, stakeholders, and the long-term value of publicly traded corporations has been the subject of substantial analysis and debate. See, e.g., Lynne L. Dallas, Short-Termism, the Financial Crisis, and Corporate Governance, 37 J. CORP. L. 265 (2012) (discussing short-termism in public markets); David Millon, Shareholder Social Responsibility, 36 SEATTLE U. L. REV. 911 (2013) (discussing short-termism, particularly of institutional investors, as an impediment to corporate social responsibility); Lucian A. Bebchuk, The Myth That Insulating Boards Serves Long-Term Value, 113 COLUM. L. REV. 1637 (2013) (arguing that board insulation does not necessarily serve long-term value).
143. See Alan Murray, Private Equity’s Successes Stir Up a Backlash That May Be Misdirected, WALL ST. J., Jan. 31, 2007, at A9 (suggesting that private equity firms may benefit from reduced short-term market pressures); Jack B. Jacobs, “Patient Capital”: Can Delaware Corporate Law Help Revive It?, 68 WASH. & LEE L. REV. 1645 (2011) (arguing that patient capital is needed to support companies creating and bringing to market innovative products and technologies, and noting developments that have reduced such patient capital particularly in public markets).
entrepreneurs are repeat players in the startup community, as are certain other stakeholders like debt lenders.

To be sure, corporate participants also discuss other roles of the startup board besides the mediating role serving the corporation’s interest. Most notably, corporate participants expect that early-stage boards of directors “should be focused on being an extension of the team, helping the entrepreneurs out of the gate, and getting the business up and running.” An early-stage board should “reinforce the CEO and the entrepreneur’s success” by “materially contribut[ing].” This support role includes “making numerous introductions to potential customers, partners, and employee candidates,” and “being available to interview/sell employee candidates, coach management team members, speak at sales kickoffs, or just about anything reasonable that a CEO asks you to do to help the business.”

The focus on supporting the corporate team could appear in conflict with the idea of a mediating hierarchy that sits above the team. However, when understood in the context of a young startup company, this emphasis on being an extension of the corporate team is not necessarily inconsistent because it is what helps the corporation grow. A startup board naturally shifts its focus over the course of the corporation’s life cycle and may have more than one function.


145. For example, Silicon Valley Bank is the largest venture lender, “the 800 pound gorilla in the room,” with perhaps 70% of the banks’ market share in the venture debt industry. Ibrahim, Debt as VC, supra note 51, at 1177.

146. Feld & Ramsinghani, supra note 50, at 81.

147. Id.

148. Id. at 56 (quoting Andreessen Horowitz partner Scott Weiss).

149. Id.; see also VC-BACKED COMPANY DIRECTORS WHITE PAPER, supra note 46, at 12.

150. See, e.g., Laniado, supra note 129 (“At early-stage startups, [board] members should support the management. . . . More established startups, however, may need a different type of assistance related to scaling sales, engineering, logistics, and other functions that no longer fit into a garage.”).
B. Toward a Better Understanding of Team Production Theory and Private Company Boards

The discussion above shows that Blair and Stout’s team production theory of the board of directors as a mediating hierarchy need not be limited to public companies. The board of directors of some VC-backed startup companies, in particular, illustrates this point. But the above discussion also shows that, for many private companies, the board of directors does not serve as a mediating hierarchy. This raises the question: Why do some private corporations reflect the mediating hierarchy model but not others?

This Essay concludes by offering some preliminary thoughts on this question. To start, one answer may be that team production problems simply do not arise in all corporations, and so we would not expect to find a mediating hierarchy model board in all corporations. To examine why this might be so, it is important to go back to the definition of the team production problem. As Blair and Stout acknowledge, in the economic literature, team production problems arise where several types of resources are used, they do not all belong to one person, and the resulting gains are nonseparable.\footnote{Blair & Stout, Team Production, supra note 2, at 281 (discussing Alchian and Demsetz’s work).} Therefore, when, for example, an individual provides the labor and capital to go into business herself and decides to incorporate, a corporation will exist that does not reflect team production. With general incorporation laws, the corporate form is widely available—team production is a common economic problem, but it is not required for forming a corporation.\footnote{Margaret M. Blair, Locking In Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century, 51 UCLA L. REV. 387, 426–27 (2003) (discussing states’ adoption of general incorporation laws in the 19th century). It is worth noting, however, that there is a long history of boards existing to resolve disputes and regulate the conduct of members in merchant societies. See Franklin A. Gevurtz, The Historical and Political Origins of the Corporate Board of Directors, 33 HOFSTRA L. REV. 89, 126–28 (2004).} The corporate form offers a variety of attractive characteristics, such as limited liability, that might encourage incorporation.

Furthermore, even if a group of people engages in team production, using different resources and creating nonseparable gains, the Blair and Stout theory does not necessarily predict that the team members will adopt a mediating hierarchy. The idea of opting into the mediating hierarchy model comes from additionally specifying that the team members’ contributions are firm-specific and that they face contracting problems because they wish to prevent shirking and rent-seeking while also allo-
cating the surplus of the joint production to team members. Consider, for example, a group of researchers who each make a different, nonseparable contribution in developing a new drug. They are engaged in team production activity, but unless they also expect to each share in the gains of such team production and seek to prevent shirking and opportunistic behavior, we might not expect them to give up control and create a mediating hierarchy. They could, however, still incorporate— their board might simply not act as a disinterested hierarchy—and if they did not each expect to share in the gains, they could adopt a vertical arrangement in which some of the team members received fixed wages or compensation.

At core, putting aside the language of “public” and “private,” Blair and Stout’s insights suggest that a team production problem might arise that would lead to adoption of a mediating hierarchy where: multiple team members make firm-specific investments of different types (i.e., labor or capital); the joint output is nonseparable; and the team members face contracting problems because they want to prevent shirking and opportunistic behavior, as well as to allocate joint output to the team members. These conditions are indeed what we see with some VC-backed startups and other private companies: multiple team members are investing firm-specific labor and capital, the joint output from such contributions is nonseparable, and the team members have potentially conflicting claims to the surplus created. They either cannot guarantee all of the team members a fixed return because the firm is sufficiently cash-strapped or the team members in any case want to be incentivized with a claim to the surplus created from the joint production. Whereas the Blair and Stout article seemed to assume that the parties could not use private arrangements to set up a mediating board (i.e., they need to go public if they want this), in fact team members in such startups and their representatives are often quite sophisticated at designing governance arrangements. Parties may bargain over control rights in the corporation and use the board as a way to create nuanced allocations of control or even a disinterested mediating hierarchy. While Blair and Stout’s intuition that we would not expect to see such a mediating hierarchy board in all corpora-

153. See supra text accompanying notes 20–28 (discussing Blair and Stout’s insights building on work by Holmstrom and Rajan and Zingales).

154. In other work by Margaret Blair, she provided an excellent historical example of a business facing these conditions that chose to incorporate with a mediating hierarchy-like structure. See Blair, supra note 152, at 442–49 (recounting the rise of the Singer Sewing Machine Company—started by Isaac Merritt Singer—which developed into a partnership plagued by the type of hold-up behavior that team production theory predicts, and then incorporated with a mediating hierarchy-like structure).
tions bears out, the potential scope of the model transcends the line drawn by federal securities laws between public and private corporations.

CONCLUSION

Few articles make a contribution of the magnitude that Professors Margaret Blair and Lynn Stout achieved in *A Team Production Theory of Corporate Law*. Drawing on the economic theory of team production, they provided a new understanding of the role of the board of directors in a corporation that stood in stark contrast to the conventional principal–agent model. Instead of casting the directors as agents of the shareholders, Blair and Stout showed that the board of directors served as a mediating hierarchy that encouraged firm-specific investment in team production. By their account, their alternative approach provided special insight into the theory of public corporations. This Essay has attempted to give more nuanced consideration to the applicability of the team production theory and mediating hierarchy model to private corporations. Through examination of private company boards, both of startup corporations and other private corporations, this Essay shows that Blair and Stout’s theory need not be limited to public corporations. Indeed, the mediating hierarchy model is clearly evinced in the evolution of startup companies that hire a board of directors, use independent directors, and understand the board as serving a dispute resolution or mediating function among corporate participants. While the board of directors does not act as a mediating hierarchy in all private corporations, Blair and Stout’s theory furthers our understanding by providing special insight into some.