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RETHINKING AGENCY THEORY: THE VIEW FROM LAW

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We draw from legal theory to offer a fundamental rethinking of agency theory along three key dimensions: redefining the principal from shareholders to the corporation, redefining the status of the board from shareholders' agents to autonomous fiduciaries, and redefining the role of the board from monitors to mediating hierarchs. These dimensions contrast with classic agency theory, offering novel conceptions that can inform further theorization and empirical research in corporate governance.

Agency theory, rooted in economics and finance thinking (Fama, 1980; Fama & Jensen, 1983a,b; Jensen & Meckling, 1976), has become a cornerstone of the corporate governance field, not only in terms of its impact on the literature but also in terms of policy and practice (Daily, Dalton, & Cannella, 2003; Dalton, Daily, Ellstrand, & Johnson, 1998; Shleifer & Vishny, 1997). Codes of good practice in corporate governance, director training, and composition and procedures of corporate boards have been influenced by agency theory tenets (Coffee, 1999; Hansmann & Kraakman, 2001; McCarthy & Puffer, 2008). While the agency problem (defined as agency conflicts arising from a divergence between agents' and principals' utility functions, creating the potential for mischief) is real and intractable, a large and growing body of empirical research on the means proposed to mitigate the agency problem has failed to support their efficacy (Dalton, Daily, Certo, & Roengpitya, 2003; Dalton et al., 1998; Dalton, Hitt, Certo, & Dalton, 2007).

Further, the control- and self-interest-oriented assumptions of agency theory (Davis, 2005; Ghoshal, 2005; Mizruchi, 1988) are deemed unsuitable for offering a rounded understanding of corporate governance systems that encompass collaborative behaviors (Sundaramurthy & Lewis, 2003) or that operate in other contexts than mature market-oriented economies (McCarthy & Puffer, 2008), are unable to explain the complexities of real-world organizations (Perrow, 1986), and go against the behavioral assumptions held by most organization theorists (Lubatkin, 2005). Accordingly, scholars have called not only for more effective methodologies—for example, how variables related to board independence, equity ownership, and the market for corporate control can be operationalized and measured—but also for new perspectives for examining foundational issues in corporate governance (Daily et al., 2003; Ghoshal, 2005).

The contested nature of agency theory's assumptions and the failure of empirical research to support agency theory tenets suggest the need to not only seek ever-finer incremental methodological amendments but, we argue, also critically reexamine agency theory itself and propose reformulations that can inform further theorization and empirical research in new directions. We draw from legal theories of the firm, derivative views of corporate governance, and corporate law principles and cases (Bainbridge 2002a,b,c; Blair & Stout 2001a; Stout 2002, 2003) to challenge and recast three fundamental tenets underlying classic agency theory as applied to corporate governance.

First, the principal in the principal-agent relationship refers to shareholders (Fama & Jensen, 1983b; Jensen & Meckling, 1976). We instead argue that the principal is not the share-

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holders but, rather, the corporation. Second, in classic agency theory the board is subservient to shareholders as a first-order agent (Eisenhardt, 1989; Mizruchi, 1988). We argue that the board is not an agent but an autonomous fiduciary—someone who is entrusted with the power to act on behalf of and for the benefit of a beneficiary; these individuals' autonomy derives from the fact that they are neither agents of nor under the control of any particular party (Blair & Stout, 2001a: 423–424). Third, in classic agency theory the main role of the board is to monitor managers to ensure that their interests do not diverge substantially from those of the principals and that they take actions maximizing principals' returns (Fama, 1980; Fama & Jensen, 1983a,b; Jensen & Meckling, 1976; Mizruchi, 1988). We contend that the role of the board is not to be a monitor but, rather, a mediating hierarch—someone who balances the often competing claims and interests of the groups that contribute to the team production process, makes decisions on the allocation of team surpluses, and is legally ultimately in control of a corporation's assets and key strategic decisions (Blair & Stout, 2001a: 404). Drawing from team production theory and organization theory, we offer three prioritization criteria for this mediating process: the team specificity of each stakeholder's investment, the need to satisfice outcomes, and the power of each stakeholder.

Following Daily et al., we define corporate governance as "the determination of the broad uses to which organizational resources will be deployed and the resolution of conflicts among the myriad participants in organizations" (2003: 371). Daily et al. (2003) suggested this definition in contrast to the dominant agency theory–inspired definitions of governance focusing on controlling managerial self-interest and protecting shareholders. This definition is in line with our focus of critically rethinking agency theory and posing a significantly different status (autonomous fiduciaries) and role (mediating hierarchs) for boards of directors.

Our key contribution therefore lies in offering a critical and constructive reexamination of agency theory that moves beyond incremental debate to a rethinking of fundamental dimensions of this theory, inspired by other work in which researchers have sought to critically examine the theory (Davis, 2005; Lubatkin, 2005; Sundaramurthy & Lewis, 2003). As far as we are aware, this is the first paper that explicitly draws in-depth from legal literature to inform and critically rethink a foundational theory of corporate governance—namely, agency theory.

CONTRACTUAL/AGGREGATE THEORY OF THE CORPORATION

One of the key legal features of the firm is that, upon incorporation, it acquires a separate and distinct legal personality (Farrar & Hannigan, 1998; Ferran, 1999). This personification of the corporation has substantial legal significance because it implies a single and unitary source of control over the collective property of its various participants. It defines and legitimates the corporation as an autonomous economic being, and it grants the corporation various rights, including constitutional rights, thereby offering corporate property unprecedented protection from and by the state (Mark, 1987; Schane, 1987).

To explain this personification phenomenon, three dominant theories on the nature of the corporation have been proposed: concession/fiction theory, contractual/aggregate theory, and realist/organic theory. These treat the corporation, respectively, as an artificial entity created by the state, as an aggregate of persons bound by contracts, and as a real entity existing naturally (Millon, 1990; Phillips, 1994; Schane, 1987). Table 1 outlines the key features of these theories. In what follows we draw in particular on the contractual/aggregate theory, since this is the theory that underlies the "shareholder primacy" model of corporate governance with which agency theory is aligned, and it has also recently given rise to the "director primacy" model of corporate governance, challenging agency theory.

Long before neoclassical economists introduced the nexus of contracts theory, early legal theorists had already employed partnership analogies to describe the corporation as an aggregate formed by voluntary private contracting among its human parts—the contractual/aggregate theory of the corporation (Beach, 1891; Morawetz, 1886; Taylor, 1902). In this view there is no distinct corporate entity (Phillips, 1994), and the corporate "whole" is nothing more than the additive sum of its "parts" (Hager, 1989).

During the second phase of development of this theory in the legal literature since 1979, and

TABLE 1
Legal Theories of the Corporation

Key Ideas	Concession/Fiction Theory	Contractual/Aggregate Theory	Realist/Organic Theory
Outline of theory	Corporation is only a state-created reification and a legal fiction. It has no substantial reality, existing only in law.	Corporation is formed by voluntary private contracting among its human parts. It is the sum of its human constituents and nothing more; there is no distinct corporate entity.	Corporation is a real entity having a separate existence from its shareholders. It can will and act through the groups of individuals who are its organs, just as a natural person can will and act through his or hers.
Time line of theoretical development	Stage 1: First part of nineteenth century until 1880s	Stage 1: 1886–1890	Stage 1: 1897–1926
	Stage 2: 1959–1970s Stage 3: 1990s–present	Stage 2: 1979–present	Stage 2: 1985–present
Key supporters in legal literature	Stage 1: Chief Justice Marshall, Associate Justices Washington and Story in *Dartmouth College v. Woodward* (1819)	Stage 1: Morawetz (1886), Beach (1891), Taylor (1902)	Stage 1: Freund (1897), Laski (1916), Canfield (1917), Maitland (1927)
	Stage 2: Latham (1959), Nader, Green, & Seligman (1976) Stage 3: Millon (1990)	Stage 2: Hessen (1979), Fischel (1982), Kraakman (1984), Coffee (1999), Hansmann & Kraakman (2001)	Stage 2: Horwitz (1985), Hager (1989), Phillips (1994), Mitchell (1995, 1999), Iwai (1999)
Nature of the firm	Firm is a fiction whose life and legal legitimacy derive from the state. In turn, the firm concedes to doing public good and subjects itself to state regulation.	Firm has no definite, independent existence; it is merely a collective term for contracts entered into by corporate constituents.	Firm is a naturally occurring being, a full-fledged subject of property ownership.
Function of law	Law creates corporation, and the charter determines its properties.	Law has little function beyond substantiation of contracts, and legal rules merely spell out what the human aggregates would have agreed to in the first place.	Law does not create corporations but merely recognizes and regulates their independent existence.
State's regulatory interference	Justified, since corporation is a legal creation whose existence derives from the state.	Not justified, since state should not have any interest in contracts between private individuals; disciplinary actions should be taken by the market rather than by the state.	Justified, since corporation is a social being that should operate under the law.
Influence on legal model of the firm	Communitarian model	• Shareholder primacy model • Director primacy model	Managerial model

drawing from concepts already present in concession/fiction theory, the corporation was seen as a "mental construct" (Hessen, 1979: 41) of humans connected with the firm or otherwise aware of it. The firm was a "legal fiction" (Jensen & Meckling, 1976), serving as a nexus for the contracting process involving the various factors of production. The relationship between shareholders and managers was governed by contracts creating a principal-agent relationship, with the main, if not sole, purpose being the maximization of shareholders' wealth (Fischel, 1982). Management was thus seen as based on a continuous process of negotiation of successive contracts with shareholders, who were viewed as the supreme corporate body. The main function of law was the substantiation and facilitation of these contracts, and the role of the state in terms of regulation was underplayed, since market-based contracting was the main organizing mechanism.

Despite the wide currency achieved by contractual/aggregate theory, legal scholars are divided with respect to its merits (Eisenberg, 1989; Horwitz, 1985; Iwai, 1999; Phillips, 1994). In addition to the theory's inconsistency with some fundamental legal concepts, such as the personification of the corporation, its single-mindedness on shareholders' wealth maximization makes it unpopular with scholars who believe that other stakeholders have legitimate and intrinsic rights (Davis, Schoorman, & Donaldson, 1997; Donaldson & Preston, 1995; Millon, 1995; Mitchell, 1992a, 1995; Parkinson, 1993).

LEGAL MODELS OF CORPORATE GOVERNANCE: SHAREHOLDER PRIMACY OR DIRECTOR PRIMACY?

The three legal views of the corporation give rise to four main legal models of corporate governance advocated in countries with an Anglo-Saxon legal system, such as Australia, Canada, the United Kingdom, and the United States. These are managerialism, the shareholder primacy model, the stakeholder/communitarian model, and the director primacy model, as outlined in Table 2.

Below we discuss the two corporate governance models arising from the contractual/aggregate theory of the firm: (1) shareholder primacy, supporting agency theory, and (2) director primacy, prompting a radical rethinking of agency theory. We then show that despite the widespread influence of the shareholder primacy model, the weight of legal precedent and corporate law support director primacy instead. We subsequently proceed to examine how director primacy enables us to reframe agency theory along key dimensions.

The Shareholder Primacy Model and Classic Agency Theory

Shareholders as principals. A key assumption of shareholder primacy, based on contractual theory, is that if the firm is a legal fiction made up of contracts (Alchian & Demsetz, 1972; Jensen & Meckling, 1976), then shareholders, as principals of the contracts, should have ultimate control. Management is simply agents who should be accountable to shareholders, where the overriding purpose should be to maximize shareholders' wealth (Fischel, 1982; Jensen & Meckling, 1976; Shleifer & Vishny, 1997).

Judicial endorsement of this governance model came in 1919, when the Supreme Court of Michigan in *Dodge v. Ford Motor Co.* (1919) formulated the principle that management must conduct corporate affairs for the benefit of shareholders, not for other stakeholders or concerns, when it rejected Ford Motor's rationale for deciding not to pay a special $10 million dividend to shareholders. Henry Ford explained that he intended to use the money to "employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes" (1919: 671). The judge, J. Ostrander, lashed out at him for wanting to run the firm like a "semi-eleemosynary institution and not as a business institution" (1919: 683).

In management research in corporate governance, shareholders assume primary importance as researchers examine how both internal and external governance mechanisms can help align the interests of managers and shareholders (Walsh & Seward, 1990) through such measures as the composition of the board of directors (Dalton et al., 1998; Hermalin & Weisbach, 1998; Johnson, Daily, & Ellstrand, 1996; Zahra & Pearce, 1989), equity ownership by executives (Demsetz & Lehn, 1985; Jensen & Meckling, 1976), and the market for corporate control (Fligstein, 1990; Jensen, 1986; Jensen & Ruback, 1983). A substantial amount of research has questioned the effectiveness of these measures, however (e.g., Baysinger & Hoskisson, 1990; Bhagat & Black, 1999; Weisbach, 1988).

Boards as monitors of management on behalf of shareholders. The agency relationship deriving from the separation of ownership and control is defined as "a contract under which one or more persons (the principal(s)) engage another

TABLE 2
Legal Models of Corporate Governance

Key Ideas	Managerialism	Shareholder Primacy Model	Stakeholder/ Communitarian Model	Director Primacy Model
Outline of model	Management is the corporate strategic center in a bureaucratic hierarchy, acting as a rational, self-disciplined mechanism. It is composed of expert professionals carrying out the objective implementation of shareholders' wishes.	Shareholders are the main residual claimants of the firm's income stream and have ultimate control over the corporation. The sole purpose of management is to maximize shareholders' wealth, and it should only engage in activities that are financially beneficial to shareholders.	Nonshareholder constituencies have stakes in the corporation that are as equally important as those of shareholders. Managers and directors should be sensitive to stakeholders' interests when making decisions.	The board of directors is a central, independent decision maker for the firm. It mediates competing interests among the various groups that bear residual risk and have residual claims over the firm, and it allocates team surpluses.
Supporting legal theory	Organic theory	Contractual theory	Concession theory	Contractual theory
Key authors in legal literature	Freund (1928), Landis (1938), Jaffe (1965)	Easterbrook & Fischel (1991), Coffee (1999)	Mitchell (1992a), Millon (1995, 2000)	Blair & Stout (1999), Bainbridge (2002a,b,c)
Time line	1928–1980s	1980s–present	1990–present	1999–present
Purpose of corporate governance structure	To devise a structure that would confer an enormous range of discretion on management so as not to curb the creativity and flexibility needed for effectively running a corporation	To address the agency problem by devising a means of reducing agency costs and aligning the interests of managers and shareholders, and, consequently, to maximize shareholders' wealth	To devise a governance structure that takes into account and balances the diverse interests of the various corporate constituents	To maximize the sum of all risk-adjusted returns enjoyed by the groups that participate in team production through mediation and control of strategic decisions by board of directors
Position of shareholders	Passive; they have little understanding of the operations of the company and rely totally on the discretion of management; they'd rather sell their shares and walk than exercise their voting power	Powerful and supreme; as shareowners and main residual claimants, they have ultimate control over the corporation, and management is accountable to them	One class of corporate constituents that may exploit the interests of other constituents; shareholders are savvy investors who could manipulate the firm to their advantage	Willingly cede control of firm to the board for their own interests; shareholders are just one stakeholder within a broader coalition, which contributes to team production
Role of directors	Figureheads with little knowledge of the operations of the firm; rubber-stamping management proposals in most instances	Agents of shareholders serving a monitoring role to ensure that professional managers do not exploit corporate inputs and resources to the detriment of shareholders	With the help of management, balance the needs of all corporate constituents, including nonshareholder ones	Mediating hierarchs who balance competing claims of contributors to team production process, allocate team surpluses, and are legally in control of corporation's assets and key strategic decisions
Position of management	Powerful; can exercise self-discipline and objective expertise	Self-interested group that will seek to maximize its own interests rather than shareholder interests	Assist the board to balance the needs of corporate constituents	One of the corporate participants who contribute to the success of the firm

person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent" (Jensen & Meckling, 1976: 308). The divergence between principals' and agents' interests leads to the agency problem, as well as agency costs arising from the attempts to mitigate this problem (Jensen & Meckling, 1976; Wiseman & Gomez-Mejia, 1998). Since agents are seen as incentive driven, their interests, defined as desired economic and other outcomes (Gieryn, 1983), can be aligned with those of the principals, and agency costs can be reduced if proper mechanisms can be put in place to reward, monitor, and control agents' behavior (Daily et al., 2003; Eisenhardt, 1989; Jensen & Meckling, 1976). In this context boards of directors—in theory, appointed by shareholders—are seen as an important monitoring mechanism of management on behalf of shareholders (Coffee, 1999; Easterbrook & Fischel, 1991; Eisenberg, 1976; Eisenhardt, 1989),[1] although they are not always successful (Mizruchi, 1983, 1988).

Given that boards are not immune to the agency problem, three principal approaches have been proposed to address this concern. The first is independence of the board from management (Fama, 1980; Jensen & Meckling, 1976; Mizruchi, 1983). The second is having directors hold equity so that board and shareholder interests are aligned (Demsetz & Lehn, 1985; Fama & Jensen, 1983b; Jensen & Meckling, 1976). And the third is the market for corporate control that can discipline managers and boards who abuse their agency roles or are ineffective (Fama & Jensen, 1983a; Fligstein, 1990; Jensen & Ruback, 1983).

Despite its tight logic, it has been argued that the corporate governance model based on classic agency theory is rather simplistic (Perrow, 1986; McCarthy & Puffer, 2008; Sundaramurthy & Lewis, 2003) and is underlain by debatable behavioral assumptions (Ghoshal, 2005; Lubatkin, 2005). Such critiques of the assumptions of agency theory appear to be supported by the equivocal results of empirical studies examining the effectiveness of agency theory prescriptions (Dalton et al., 2003; Dalton et al., 1998; Dalton, Daily, Johnson, & Ellstrand, 1999; Dalton et al., 2007; McConnell & Servaes, 1995; Short, 1994).

The Director Primacy Model and Team Production

Shareholder primacy in question. Even though *Dodge v. Ford Motor Co.* (1919) argues for shareholders' rights as primary, the courts have only cited this case once in an unpublished decision (Stout, 2007), which indicates the weakness of both its precedent value and its influence on legal doctrine. Corporate law in most Anglo-Saxon countries still confers ultimate power to directors, not shareholders (Bainbridge, 2002b; Ferran, 1999; Stout, 2002). As Blair and Stout observed, "Shareholders' rights over directors are remarkably limited in both theory and practice" (1999: 252). Shareholders of corporations with broadly dispersed shareholdings are generally passive, as originally pointed out by Berle and Means (1932), a situation nearly as true today (despite some funds being more activist than others) as when Berle and Means made their statement.

After analyzing the outcomes of the grand total of twenty-four cases in the United States during 1996–2005 in companies with over $200 million market capitalization, where shareholders opposed director elections with their own candidates, Bebchuk (2007) found that the challengers won in only eight of these cases. He concluded that "for directors of public companies, the incidence of replacement by a rival slate . . . is negligible" (Bebchuk, 2007: 677) and that the power of shareholders to remove directors is little more than a myth. Similarly, despite recent developments, laws concerning shareholder voting power and derivative actions remain relatively weak in terms of the success of litigation, offering insufficient protection or scope for shareholders to substantially influence the corporation.

Director primacy and the firm as a team production. Such considerations prompted a number of legal theorists to look beyond the "standard model" of shareholder primacy (Hansmann & Kraakman, 2001) for a satisfactory answer. They proposed a new model of corporate governance—the director primacy model (Bainbridge 2002a,b,c;

[1] In line with this thinking, a parsimonious view of board functions offers a twofold conceptualization: monitoring management and providing resources (Hillman & Dalziel, 2003). A broader conceptualization of board functions includes controlling managerial opportunism (Johnson et al., 1996), evaluating and rewarding the CEO and senior executives, and planning for CEO succession.

Blair & Stout 2001a; Stout 2002, 2003)—more closely aligned with legal doctrine and precedent, as outlined in Table 2. In the director primacy model the firm is viewed as a team production (Blair & Stout, 1999), defined as a complex productive activity involving several parties where the resulting output is neither separable nor individually attributable. In this view shareholders are one of several parties that make a contribution and so should not be the only residual claimants of the firm (Blair & Stout, 2001a); other nonshareholder groups, such as employees, creditors, managers, and local government, make contributions so that an enterprise will succeed (Kaufman & Englander, 2005; Stout, 2002). The assets contributed are generally firm specific and, once committed to team production, cannot be withdrawn and sold elsewhere for their full value (Blair & Stout, 2001a).

For instance, employees make firm-specific investments through giving their labor and time and through colocating. Shareholders and debt holders make firm-specific investments through contributing their capital. Suppliers make firm-specific investments through providing credit facilities and producing customized inputs. Suppliers may also often make significant relational investments through locating factories close to the firm, placing their own employees within the firm to participate in such processes as product design and innovation, and developing their capabilities in line with the customer's supply requirements (Dyer, 1996; Dyer & Singh, 1998).

Given the presence of firm-specific investments, and contrary to the economic assumption that parties are always free to negotiate the best deal that protects their interests in a contractual arrangement, contracts in the team production setting are difficult to design so as to provide adequate incentives for each team member to make optimal contributions to the team (Blair & Stout, 2001a: 419). To address this problem, the team members willingly delegate authority over the division of production rents and surpluses to an independent body—a mediating hierarch in the form of the board of directors—which will monitor their efforts and determine how each can best be rewarded for past contributions, as well as be incentivized for future contributions, in the process also guarding against mutual opportunism among the parties. The role of corporate governance in this view, thus, is to provide a structure that will maximize the sum of risk-adjusted returns enjoyed by all groups that participate in the firm by positioning the board of directors at the top of the firm hierarchy, mediating the horizontal disputes among team members that may arise along the way (Blair & Stout, 1999: 264; Blair & Stout, 2001a: 404).

In the director primacy model of corporate governance, therefore, the board of directors is seen as a key decision-making body (Bainbridge 2002a,c) whose decisions on such matters as CEO appointment and compensation, response to takeover attempts, mergers and acquisitions, and shareholder dividends, as well as powers to review and control other major strategic decisions, provide a framework for the myriad decisions made by managers. Even though the board usually does not make all strategic decisions, it has the legal right of control over them, as well as the legal obligation as a fiduciary to review those decisions and ensure that they are in the best interests of the corporation.

RETHINKING AGENCY THEORY: THE VIEW FROM LAW

Redefining the Principal: From Shareholders to the Corporation

Along the lines of the director primacy model, courts in the United States have on several occasions clearly stated that directors are not agents of the shareholders but fiduciaries of the corporation.[2] Section 172 of the U.K. Companies Act 2006, moreover, requires directors to act in the way they consider, in good faith, would be most likely to promote the long-term success of the company for the benefit of its members as a whole, heeding the likely consequences of their decisions on stakeholders such as customers, suppliers, and community, not simply the shareholders. The law even allows the board to put the interests of other stakeholders over and above those of shareholders, which has been particularly apparent in takeover and bankruptcy cases (Bamonte, 1995; Mitchell, 1992b).

For instance, the U.S. District Court for the Eastern District of Pennsylvania held, in a preliminary injunction hearing, that a board did not breach its fiduciary duties to shareholders by

[2] Key cases include *Sears v. Hotchkiss* (1853), *Hoyt v. Thompson's Executor* (1859), *Elmes v. Duke* (1902), *Enyart v. Merrick* (1934), *Ripley v. Storer* (1955), and *Decana Inc. v. Contogouris* (2007).

rebuffing a rival bid in favor of a less lucrative offer that they believed provided better protection for employees (*Norfolk Southern Corp. v. Conrail Inc.,* 1997). In *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.* (1991) the Delaware Court of Chancery held that when a corporation became insolvent or near insolvent, shareholders could not deal with the assets as they saw fit, and directors owed a fiduciary duty to protect the assets for the benefit of the corporation, including the creditors (Kandestin, 2007). This principle has been followed in a number of subsequent cases (e.g., *Jewel Recovery, L.P. v. Gordon (In re Zale Corp.),* 1996, and *Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (In re Buckhead America Corp.),* 1994).

One of the key arguments of advocates of shareholder primacy as well as of classic agency theory is that since shareholders own the corporation, they are the main residual claimants and should therefore enjoy primacy over other stakeholders (Jensen & Chew, 2000; Jensen & Meckling, 1976). This argument is based on a misinterpretation of the legal position on the issue of share ownership, and it ignores the legal principles of personification of the corporation, of limited liability of shareholders, and of personal and potentially unlimited liability of directors. Once shareholders subscribe to shares in the corporation, payment made in consideration for the shares is considered property of the corporation, and the shareholders are not free to withdraw the sum invested except for payments through dividends, selling their shares, and other permitted means (Farrar & Hannigan, 1998; Ferran, 1999). Shareholders own the shares, not the corporation itself, which is an autonomous legal entity. As Fama noted, "Ownership of capital should not be confused with ownership of the firm" (1980: 290).

Further, the personification principle (*Lomman v. Lieb,* 1965) holds that the corporation is a legal entity that can hold property and engage in legal proceedings in its name without engaging the shareholders, and it is the corporation, not the individual shareholders, that is liable for its debts (Farrar & Hannigan, 1998; Ferran, 1999). *Lomman v. Lieb* states clearly that "it would be an unwarranted extension of the officer-director limited fiduciary rule to hold that an employee of the corporation may also under certain circumstances owe this duty to a shareholder" (1965: 313).

The principle of limited liability of shareholders further weakens the claims of shareholder primacy because it limits the risk to what they have invested in the corporation, but it does not limit the upside potential.[3] Shareholders can exercise their voting power in their own interests, even if these interests conflict with the interests of the corporation (*Good v. Texaco, Inc.,* 1985); they owe no fiduciary duties to the corporation. Directors, however, have potentially unlimited personal liability if they are found to have breached their fiduciary duties to the corporation (*Regal (Hasting) Ltd v. Gulliver,* 1942), which could be invoked by courts in a variety of situations, including insolvency cases.

Drawing from a view of law as an instrument of adaptation and as a potent "heuristic for determining the acceptability of alternative decision-making criteria and choices" (Sitkin & Bies, 1993: 346), we therefore argue that agency theory should be redefined so as to recognize the corporation itself, rather than the shareholders, as the principal. Such a redefinition would align agency theory more closely both with legal doctrine and precedent, as well as with current thinking on the societal role of the corporation.

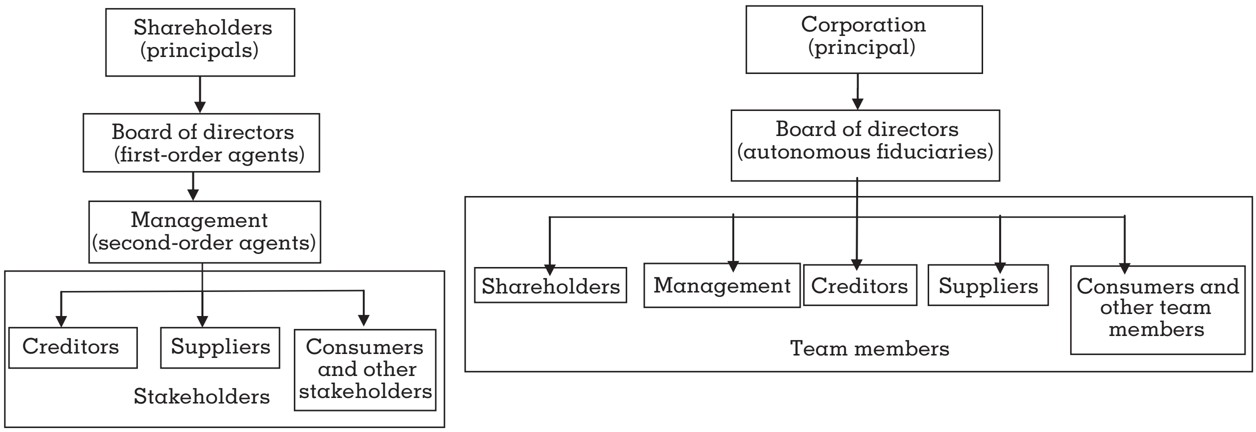
Figure 1 provides a pictorial comparison between the shareholder primacy model (where shareholders are principals) and the director primacy model (where the corporation is principal).

Redefining the Status of the Board: Directors As Autonomous Fiduciaries of the Corporation

Legal scholarship and cases suggest that the relationship between a director and the corporation is unlike that between the normal agent and principal and is, to a large extent, sui generis or unique (Bainbridge, 2002c; Clark, 1985; Harvard Law Review Association, 1941; *Regal (Hasting) Ltd v. Gulliver,* 1942: 330)—a "distinct legal relationship" that is unlike a normal agency or trustee relationship (*Enyart v. Merrick,* 1934). In this context directors' powers in no

[3] We thank an anonymous reviewer for raising the issue of shareholders' limited liability.

FIGURE 1
Comparison of Shareholder Primacy and Director Primacy Models



Shareholder primacy model (agency theory) **Director primacy model**

way derive from an agency relationship with shareholders; they are, rather, "original and undelegated" (*Hoyt v. Thompson's Executor,* 1859: 261; *Ripley v. Storer,* 1955: 289). According to Judge Walter at the Supreme Court of Oregon,

> It . . . is true that corporate directors are not in any strict sense agents of the stockholders, that their powers are conferred upon them by law, and in a very important sense are original and undelegated, that *they have an obligation to act for the corporation, that they are to a very large extent free from stockholder control,* and that no agreement or by-law which deprives them of their power to act for and in the best interest of the corporation is valid (*Ripley v. Storer,* 1955: 289; emphasis added).

Blair and Stout make this point forcibly by noting that "directors are not, in any legal sense, anyone's 'agents'. . . . directors do not owe any duty of obedience to shareholders or to anyone else" (2001a: 423–424).

This position arises because while directors are formally elected by the shareholders, to allow the corporate enterprise to function, they must be able to make business decisions within the bounds of what they consider reasonable risk, without fear that their decisions will be continuously second-guessed ex post (Frankel, 1983; *Hoyt v. Thompson's Executor,* 1859; Marchesani, 2007; *Ripley v. Storer,* 1955). Permission generally has to be obtained from the courts by any shareholder to pursue an action against directors for alleged breach of duty, because such a course of action is seen as rightly belonging to the corporation, not to individual shareholders. The emphasis that directors must be presumed to exercise independent judgment, even if this may place the shareholders' interests below those of other stakeholders under the requirements of the law (e.g., under Section 173 of the U.K. Companies Act 2006 and under the American business judgment rule, as well as by exculpation and indemnity rules), buttresses directors' roles as autonomous fiduciaries of the corporation.

Following the weight of corporate law and legal precedent, the director primacy model (Bainbridge 2002a,b,c; Blair & Stout, 2001a; Stout, 2002, 2003) therefore positions directors as autonomous fiduciaries, not agents (Clark, 1985; Ferran, 1999). In law a fiduciary individual is someone who is entrusted with the power to act on behalf of and for the benefit of another. The term fiduciary derives from the Latin *fiducia,* or trust, and the fiduciary is expected to act in good faith and honesty for the beneficiary's interests. A person who accepts the role of fiduciary in law must single-mindedly pursue the interests of his or her beneficiary, in this case the corporation (Model Business Corporation Act § 8.30), even when the latter cannot monitor or control the fiduciary's behavior (Blair & Stout, 2001b; Clark, 1985). If fiduciaries fail in their task, the courts aim to condemn them in terms that are "didactic and full of moral fervor" (Blair & Stout, 2001b:

1783; Clark, 1985; Frankel, 1983). Fiduciary duty law thus acts by shaping and reinforcing social norms of careful and loyal behavior, rather than simply by threatening liability (Eisenberg, 1999), as in a contractual relationship.

In a multitude of legal cases, judges have refused to allow shareholders to overrule board decisions on management matters,[4] and common law courts have from early on in the life of the modern corporation supported centralization of power within the board. The legal system and legal precedent thus point to the doctrinal inefficacy of shareholder primacy (under the law, directors are expected to use their independent judgment to make decisions that are in the interests of the corporation, even if this is contrary to shareholders' interests), as well as its practical inefficacy (the courts have consistently upheld the high levels of autonomy of directors).

Under the director primacy model, directors are motivated not only by the extrinsic compensation package but also by their director status and its implied trustworthiness (the ability to inspire trust; Mitchell, 1995, 1999)—the attribute that sets a fiduciary relationship apart from a contractual relationship in law (Blair & Stout, 2001b). In this sense the director primacy model is aligned with stewardship theory that assumes trustworthiness, intrinsic motivation, need for self-actualization, collective orientation, and self-control of a person placed in a situation with high involvement orientation (Davis et al., 1997; Mayer, Davis, & Schoorman, 1995; Sundaramurthy & Lewis, 2003). It also implies that it would be essential to appoint directors who inspired trust (Blair & Stout, 2001b; Schwartz, Dunfee, & Kline, 2005)—"a psychological state comprising the intention to accept vulnerability based upon positive expectations of the intentions or behavior of another" (Rousseau, Sitkin, Burt, & Camerer, 1998: 395), rather than merely based on structural criteria or on narrow interpretations of independence.[5]

Individuals' predisposition is thus relevant in understanding stewardship-oriented behaviors in the context of corporate governance. However, we concur with Jensen that we cannot "simply assume managers would do the right thing" (2008: 168) in the absence of other institutionalized constraints and internalized norms. In other words, even in situations where one party trusts another, there need to be avenues for redressing breach of trust—in this case the legal system. This observation holds whether trust and governance mechanisms are seen as complements or as substitutes (Puranam & Vanneste, 2009). Thus, it could be argued that the law as an institutional feature has shaped stewardship behavior by both providing a normative context and posing the threat of sanctions as a last resort.

Redefining the Role of the Board: From Monitors to Mediating Hierarchs

From the perspective of team production theory, the public corporation is not a "nexus of contracts (explicit or implicit)" but, rather, a "nexus of firm-specific investments" (Blair & Stout, 1999: 275; see also Alchian & Demsetz, 1972, and Stout, 2002) where shareholders are not the only residual claimants of the firm, as proposed by neoclassical economics (Easterbrook & Fischel, 1991). Contributors to the team production process cede control of their team-specific investments to an independent party (the board) in order to reduce uncertainty and dependency among team members and to avoid the transaction costs they would otherwise incur in having to negotiate ex ante more complete contracts.

The team production model does not imply that all team members will necessarily receive an equal or objectively fair share of the surplus generated through team production. The board's main task here as a mediating hierarch is to balance team members' competing interests in a fashion that keeps everyone content enough so that the productive coalition holds together (Blair & Stout, 1999; Stout, 2003). For a board to effectively carry out this role and guard against mutual opportunism, it needs to be independent

[4] Landmark cases include *Hoyt v. Thompson's Executor* (1859), *Automatic Self-Cleansing Filter Syndicate Co Ltd v. Cunningham* (1906), and *Massey v. Wales* (2003).

[5] Independence is a construct that is challenged by a resource dependence perspective, since one key function of directors is to contribute resources (Hillman & Dalziel, 2003), and that has received mixed empirical support as a means of alleviating the agency problem, a situation compounded by the plethora of operationalizations of the concept of independence (e.g. Dalton et al., 1998, 2007; Westphal, 1999).

not just from shareholders but from all stakeholders (Millon, 2000: 1027).

Given the board's role as a mediating hierarch, a key challenge would be to devise a system of prioritization to assist directors in making choices among competing interests. Drawing from team production theory and organization theory, we suggest three criteria in this prioritization process. The first is the team specificity of investment of each stakeholder (the higher the specificity the higher the priority), where team specificity of investment is inversely proportional to ease of exit. The team specificity of creditors is higher than that of shareholders, for example, given that shareholders can more easily liquidate their shares in a publicly owned corporation compared to creditors calling for the swift settlement of a sizable loan. Consistent with this criterion, the law holds that the fiduciary duties of the board may be discharged in favor of creditors over shareholders when a corporation is insolvent or near insolvency (*Asmussen v. Quaker City Corp.,* 1931). This position is strengthened by the provision that if a corporation that is near insolvency prolongs its business operations while its value continues to drop, to the detriment of the creditors, the corporation's directors, officers, and controlling shareholders are then liable to the creditors (*Credit Lyonnais Bank Nederland v. Pathe Communications Corp.,* 1991; *Production Resources Group, L.L.C. v. NCT Group, Inc.,* 2004).

The second criterion is satisficing outcomes for each group of stakeholders so that they sustain their support and contribution to the team production process. The assumptions here are that by satisficing or achieving "good enough" (Simon, 1955: 118) outcomes for each group of stakeholders, and by making decisions that do not alienate any particular stakeholder group, the contributions to team production are sustained. In takeover cases, for example, if the board feels that an offer would not be beneficial for the firm as a whole and the firm should remain independent (e.g., to sustain certain community links and relational capital or to retain talent), it can resist the offer even if shareholders decide to accept it. For instance, in *Panter v. Marshall Field &* Co. (1981) the court upheld the legality of Marshall Field board's using defensive measures to thwart a tender offer from Carter Hawley Hale (subsequently abandoned) that the board considered undervalued the firm (although not thought so by shareholders, since a premium of over 100 percent was offered). The court noted that directors of publicly owned corporations do not act outside the law when they, in good faith, decide that it is in the best interest of the company to remain an independent business entity. Further, when directors approve share option plans intended to retain management talent, shareholder challenges to these plans usually fail (*Eliasberg v. Standard Oil Co.,* 1952; *Gottlieb v. Heyden Chemical Corp.,* 1952).

The third criterion derives from the contingency theory of intraorganizational power. The higher the stakeholders' power, the higher their priority in board decision processes. Stakeholder power depends on the ability of stakeholders to help the firm cope with uncertainty, their centrality (interlinkage with other subgroups), and their nonsubstitutability (Hickson, Hinings, Lee, Schneck, & Pennings, 1971). The theory suggests that the higher these factors, the more important a subgroup is and, therefore, the higher its power. Even though this theory was originally developed as applicable to intraorganizational groups, the criteria it suggests can apply to stakeholders more broadly. More recently, Jawahar and McLaughlin (2001) developed a line of reasoning with close affinities in the context of stakeholder theory, to suggest that the importance of different stakeholders varies according to the organizational life cycle, and so do the strategies that firms employ to deal with them.

Considering the three criteria with regard to shareholders, for example, even though their investment has relatively low team specificity (in the sense that the ease of exit is high), the returns would need to be attractive enough to maintain their support (the second criterion). Further, shareholders as a whole are relatively powerful because they are largely nonsubstitutable (even though individual shareholders are), their inputs are central, and their continued support helps the firm deal with uncertainty, for example, by enabling directors to make riskier strategic decisions than they would otherwise. This means that shareholders would receive serious consideration in a strategic decision, unless the effects on other stakeholders would be comparatively adverse, as might occur in takeover or bankruptcy situations.

Given that the typical issues that boards deal with are "wicked" problems (ill-defined, ongoing problems interlinked with other problems, in which competing objectives are involved and there are no clear or optimal solutions; Rittel & Webber, 1973) where debate and judgment are needed to balance competing interests, we believe that it would be premature to offer a general theory of weight and prioritization for these criteria. Each situation would need to be examined on its own merits, and the prioritization and weighting might be different in each case; therefore, empirical research in a variety of decision situations would be needed to explore the extent to which these criteria are employed, which criteria are prioritized in different situations, and why.

DISCUSSION AND CONCLUSION

Rethinking Agency Theory

We argued that the failure of empirical research to support agency theory tenets and the bounded and contested nature of the theory's assumptions suggest the need to critically reexamine this theory and propose reformulations that can inform further theorization and empirical research. We drew from legal literature—in particular, the contractual/aggregate view of the corporation and the derivative director primacy model of corporate governance—as well as corporate law and cases, to suggest a rethinking of agency theory along three key dimensions: redefining who the principal is, redefining the status of the board, and redefining the role of the board. Table 3 summarizes how the director primacy model and team production theory can contribute to a rethinking of agency theory, grounded in the shareholder primacy model.

The legal position on the corporation as principal (where the corporation is defined as a legal entity acting as the nexus for contracting among several parties/stakeholders contributing to team production) is consistent with the tenets of stakeholder theory, including its descriptive dimension (the corporation as a constellation of cooperative and competing interests), normative dimension (these interests are legitimate and intrinsic), and instrumental dimension (corporations that engage in effective stakeholder management will achieve higher performance; Donaldson & Preston, 1995; Freeman, 1984). It is also consistent with the assumptions of stewardship theory, including a view of human nature as collectivist and cooperative rather than individualist and opportunist, and it assumes goal alignment among parties, rather than role conflict (Davis et al., 1997; Sundaramurthy & Lewis, 2003).

One appeal of the director primacy model and the related team production theory of the firm lies in their being "positive theories." By contesting the assumption of self-interested and potentially unscrupulous managers and directors in the shareholder primacy model and agency theory, these theories offer an alternative to management research on this theme that has so far been dominated by such a "gloomy vision" (Ghoshal, 2005: 86).

In this reframed view of agency theory, for example, the conception of management changes. As illustrated in Figure 1, rather than being viewed as an agent of shareholders that should be closely monitored by the board of directors to ensure that management acts in the best interests of shareholders, management is seen as one of the groups contributing to team production, where the corporation is the principal. As implied in Table 3 (assumptions on human nature), rather than seeing management as an untrustworthy, opportunistic body, the perspective shifts to viewing management as a bona fide cooperative team member.

Further, rather than an assumption of an inherent goal conflict between management (agent) and shareholders (principals), the assumption becomes one of goal alignment within a team production process, between management (team member) and corporation (principal), with the board of directors serving as a mediating hierarch balancing competing interests and mediating any disputes that arise in order to ensure continued productive contributions from all members of the team. As noted in Table 2, the main economic problem from this perspective is not how to minimize agency costs (where management is seen as an agent) but, rather, how to maximize the sum of all risk-adjusted returns enjoyed by all the groups that participate in team production.

The concept of mediating hierarch in particular, we argue, can help researchers get closer to the actual work of directors, which cannot be explained or accounted for by traditional

TABLE 3
Rethinking Agency Theory: The Contribution of Director Primacy Model and Team Production Theory

Key Ideas	Shareholder Primacy Model and Agency Theory	Director Primacy Model and Team Production Theory
Outline of theory	Principal-agent relationships should reflect the optimal arrangement that will reduce agency costs by the managers/agents. Boards monitor managers on behalf of shareholders.	Firms involve team production. The board of directors should be accepted as a fair and trustworthy mediating hierarch so that the various members of the team cede control to the board.
Origin	Economics and finance	Law and economics
Nature of the firm	A nexus of contracts voluntarily negotiated among the rationally selfish and individualist parties who join in the corporate enterprise	A nexus of firm-specific investments; a complex productive activity involving many parties where the resulting output is generally neither separable nor individually attributable to original contributors
Key relationships under the theory	Shareholders as principals, management as agents, and boards as monitors of agents	Corporation as principal, board as mediating hierarch, and the rest of the corporate stakeholders as team members
Unit of analysis	Contract between principal and agent	Firm-specific investment by each team member and mediation process
Assumptions on human nature	Individualist, opportunist, extrinsic motivation, distrustful, untrustworthy, incentive driven	Collectivist, cooperative, intrinsic motivation, trustful, trustworthy, fairness driven
Goal assumptions	Goal conflict (risk differential between principals and agents)	Goal alignment (stakeholders cede control to board)
Role of corporate governance	To devise a structure that will create incentives to minimize agency costs, align managers' and shareholders' interests, and maximize shareholders' wealth	To devise a structure that will maximize the sum of risk-adjusted returns enjoyed by all groups that participate in the firm by placing the board of directors at the top of the firm hierarchy to make key decisions, mediate horizontal disputes, and allocate team surpluses
Status and role of the board	Board is shareholders' agent and has to monitor management on behalf of shareholders	Board is an autonomous fiduciary of the corporation and acts as a mediating hierarch
Utility functions	Aim toward maximizing shareholder returns to the exclusion of other stakeholders	Aim toward maximizing total returns and satisficing group-specific stakeholder returns so that commitment to team production is sustained
Monitoring mechanisms over management	Board of directors, market for corporate control, CEO compensation	Peer review by other stakeholders, disagreements mediated by board with the view of achieving sustained contribution to team production
Managerial opportunism and shirking	Inherent to human condition and dealt with through monitoring mechanisms; reactive approach	Role of board as mediating hierarch with ultimate control powers acts as a detriment to mutual opportunism and shirking; proactive approach
Board independence	Independence of board from management as well as from major shareholders is crucial so as not to compromise its monitoring role	Independence of board from all stakeholders is crucial so as not to compromise its mediating role
Market for corporate control	A monitoring mechanism for ineffective managers. Anti-takeover provisions impose unnecessary and inappropriate agency costs on shareholders.	May constrain team production because of its destabilizing consequences. Anti-takeover provisions can foster team production by enhancing stability and predictability.
Policy-oriented proposals	Shareholder activism, regulations that allow shareholders to express dissatisfaction	Director autonomy, legal system that supports and upholds director primacy

agency theory (Roberts, McNulty, & Stiles, 2005). Although the mediating hierarch concept has been noted in the management literature on corporate governance (Daily et al., 2003: 379), it has not been extensively developed or applied further (for an exception see Frey & Osterloh, 2005). In this light we offered three prioritization criteria of stakeholders drawn from legal and organization theory: the team specificity of investment, the need to satisfice outcomes, and the relative power of the stakeholders, whose validity can be further examined in actual board decision-making situations.

We hope that the reframing of key aspects of agency theory suggested here can potentially redirect lines of inquiry by encouraging researchers to overcome the barrier of "empirical dogmatism" (Daily et al., 2003: 379) arguably inherent in much of current corporate governance research.

Avenues for Testing Legal Agency Theory

In this section we offer propositions that can be used to test the main features of the legal agency theory we advanced in this paper.

Redefining the principal: From shareholders to the corporation. We argued first that legal theory, statutes, and case law pose and uphold the corporation, rather than the shareholders, as principal. Based on our definition of the corporation as a legal entity acting as the nexus for contracting among several parties/stakeholders contributing to team production, decisions that are in the corporation's interests would aim to balance the various stakeholder interests involved in team production. Second, we noted that this position is consistent with the tenets of stakeholder theory, including its instrumental aspect, linking effective stakeholder management with higher corporate financial performance.

Following from the above, a third consideration is that corporate performance can be viewed not only financially but also in terms of stakeholder-relevant measures. Empirical research indicating positive correlations between a stakeholder corporate view of success and higher financial returns to shareholders (Ruf, Muralidhar, Brown, Janney, & Paul, 2001; Verschoor, 1998; Waddock & Graves, 1997) shows that corporate priorities are not necessarily a zero-sum game. Stakeholder-oriented performance measures could include, for example, the ability to attract and keep good employees, social responsibility with regard to community, and product quality and innovativeness with regard to customers (Chakravarthy, 1986).

Proposition 1a integrates the first two considerations.

> *Proposition 1a: Boards of directors that make decisions in the interests of the corporation rather than solely in the interests of shareholders will achieve higher corporate financial performance.*

Proposition 1b integrates the second and third considerations.

> *Proposition 1b: Boards of directors that make decisions in the interests of the corporation rather than solely in the interests of shareholders will achieve higher corporate performance in terms of specific stakeholder measures.*

Redefining the status of the board: From shareholders' agents to autonomous fiduciaries. We argued first that, according to corporate law, legal theory, and legal precedent, directors are not agents of the shareholders but, rather, autonomous fiduciaries of the corporation. Our definition of the corporation implies that a board of directors acting as an autonomous fiduciary would make decisions in the corporation's interests rather than solely in shareholder interests. Second, we suggested that since trustworthiness (the ability to inspire trust) is integral to the concept and practice of being a fiduciary, trustworthiness would be a key criterion in director selection, a position consistent with the assumptions of stewardship theory. Third, and following from the above, we posit that directors whose selection includes the criterion of trustworthiness would be more likely to act as autonomous fiduciaries of the corporation than as agents of shareholders—that is, to make decisions in the interests of the corporation.

Proposition 2a relates to the first consideration.

> *Proposition 2a: Directors acting as autonomous fiduciaries of the corporation will make decisions in the corpo-*

ration's interests rather than solely in shareholders' interests.

Proposition 2b integrates the second and third considerations.

> *Proposition 2b: Directors whose selection includes the criterion of trustworthiness are more likely to act as autonomous fiduciaries of the corporation than as agents of the shareholders.*

Redefining the role of the board: From monitors to mediating hierarchs. We argued first that since boards are legally required to act in the interests of the corporation rather than solely in shareholders' interests, they have to balance competing interests, in the process also guarding against mutual opportunism. Their role, therefore, is to be mediating hierarchs rather than monitors of management. Second, drawing from both the legal literature and management literature, we proposed three prioritization criteria for fulfilling this mediating hierarch role and suggested that the validity of these criteria should be examined empirically. Third, we hypothesize that boards that employ these prioritization criteria will be more effective in their mediating hierarch role. Effectiveness in their mediation role can be evaluated on the basis of specific stakeholder measures.

Proposition 3a integrates the first and second considerations.

> *Proposition 3a: When mediating among competing interests, boards employ the prioritization criteria of team specificity of investment, satisficing outcomes, and relative power of stakeholders.*

Proposition 3b tests the third consideration.

> *Proposition 3b: The employment of the three prioritization criteria by a board and the effectiveness of that board as a mediating hierarch are positively correlated.*

Proposition 3c integrates the third consideration with empirical evidence suggesting that a stakeholder orientation and higher financial performance need not be seen as conflicting but, rather, are positively correlated.

> *Proposition 3c: A board's effectiveness as a mediating hierarch and corporate financial performance are positively correlated.*

Engaging with Legal Theory

We submit that beyond the agency theory theme focused on here, legal theory can make further contributions to management and organization theory. We outline below how two domains—institutional theory and the nature and scope of the firm[6]—might benefit from engagement with legal theory.

Institutional theory. Since the three pillars of institutions (regulative, normative, and cultural cognitive) are closely intertwined (Scott, 2001) and legislation is a central regulative agent (Scott, 2005),[7] a more in-depth engagement with a legal perspective can contribute to understanding the factors affecting the diffusion and decline of institutional norms (shared understandings that give rise to established organizational arrangements; Scott, 2005). It would be useful to understand, for instance, the extent to which isomorphism in specific organizational arrangements within the same legal jurisdictions is due to relevant legislation rather than simply mimetic processes. This might include consideration of how employment law influences human resource management arrangements, or how international accounting standards influence processes of accounting, both in a numerical sense and in an ethnomethodological sense (corporations' and agents' explanations when called on to account for specific actions or inactions). Conversely, a change in legislation may become a potent entropic force that leads to the decline of existing institutionalized arrangements, or it could spur the birth of new institutional arrangements.

Further, institutional environments contain a variety of heterogeneous elements across the three pillars, which may be misaligned or in conflict (Scott, 2005). A nuanced study of the regulative dimension can contribute to mapping more accurately the interaction of institutional elements across the three pillars and, in doing so, to understanding why and how certain insti-

[6] We thank the associate editor for directing our attention to these domains.

[7] To the extent that the legal system has normative force, it is also relevant to the normative pillar; the three pillars are analytically distinct but not distinct in practice.

tutional logics dominate. For example, organizations are subject to significant institutionalized legal constraints on issues relating to work conditions, the environment, accounting, and labor. A gap in our understanding of the legal aspects of the regulative dimension implies a gap in our understanding of institutional aspects in the normative and cultural cognitive dimensions with regard to these issues.

Nature and scope of the firm. Legal theory can also enrich the debate on the nature and scope (or boundary) of the firm, directing debate beyond the role of transaction costs (Williamson, 1981). Coase explained that firms owed their existence to the simple fact that "there is a cost of using the price mechanism" (1937: 390); therefore, not all organizing activities can be left to the market. He later elaborated that this cost includes identifying parties, negotiating with them, drawing up contracts, and monitoring the fulfillment of the terms of contracts (Coase, 1960: 15). This view of the firm as a nexus of contracts involving transaction costs, underlying classic agency theory, leads to a conception of the scope of the firm as being determined by these costs (1937: 404).

However, Coase's (1960) contributions on the problem of *social* cost, which drew significantly on legal theory and cases, open up the possibility for a view of the firm as a team production (a nexus of firm-specific investments). Coase noted that "the cost of exercising a right (of using a factor of production) is always the loss which is suffered elsewhere in consequence of the exercise of that right" (1960: 44), thus highlighting the interconnectedness of productive processes and parties to these processes. His conclusion that "in devising and choosing between social arrangements we should have regard for the total effect" (1960: 44) indicated the need to balance competing interests and injected a social dimension to individual property rights. In this context the scope of the firm is reached not just through consideration of transaction costs but also through consideration of the broader effects on stakeholders of decisions on such issues as takeovers, down-scoping, or internationalization, as directors are legally obliged to do.

If we consider the legal views of the firm more broadly (as outlined in Table 1), the view proposed by concession/fiction theory—that the firm is derived from the state and therefore concedes to doing public good and subjecting itself to law—is consistent with team production theory and further reinforces the move beyond an economic conception of the scope of the firm. In doing so it also supports the normative dimension of stakeholder theory (Donaldson & Preston, 1995), accepting, through the notion of public good, that stakeholders have legitimate interests with intrinsic value. Further, the personification principle underlain by realist/organic theory (the firm as a legal person and a full-fledged subject of property ownership), together with other legal considerations noted earlier, weakens the shareholder primacy assumption that shareholders own the firm and are the main residual claimants.

Boundary Conditions of Legal Theory

It is important to specify the boundary conditions (considerations delimiting applicability) of legal theory. First, the normative nature of legal theory means that it tends toward prescription rather than description, posing limits on how it can be used empirically. Consistent with how we use it, legal theory is more suitable for conceptual analysis than for description of actual organizational or social situations. Descriptive, empirical analyses can best be achieved by combining legal theory with relevant management and organization theories. Second, the underlying assumptions of the specific legal theories used pose boundaries on their empirical validity. This leads to the need to clarify these underlying assumptions so as to enhance robustness of both theoretical development and empirical research. If the assumptions (as noted, for example, in Table 3) of a specific legal theory such as team production do not empirically hold, then the validity of this theory will be severely compromised.

Finally, there are boundary conditions relating to the features of the organizational and institutional context, also posing a limit on the empirical validity of specific legal theories. For example, the effectiveness of a board in carrying out its mediating hierarch role will be higher when shareholdings are dispersed, since it will be easier to maintain independence from specific shareholders, but it will be hampered when there is a major shareholder who is more likely to take an interest in strategic decisions that are under the jurisdiction of the board (Fama & Jensen, 1983b; Leech, 1987). Further, in institutional environments where corruption is systemically ingrained, any model of corporate governance will be severely compromised. Therefore, legal theory and concepts cannot be divorced from the empirical settings in which they are intended to apply, since they must meet tests of relevance and efficacy, especially with regard to such an applied domain as corporate governance.

Practice Implications

There are several practice implications of our arguments. An understanding of the director primacy model and its legal roots, as well as its assumptions (as detailed in Table 3), would help managers, investors, policy makers, and other stakeholders understand why the legal system has historically afforded directors protection from undue challenges by stakeholders (including shareholders) so that they can effectively carry out their fiduciary duties to the corporation—the principal, from a legal perspective. Further, the popular focus on independence of directors from management would shift toward independence from all stakeholders so that they could more effectively carry out their mediating hierarch role.

With regard to specific board processes, the focus on director selection would shift toward attributes of trustworthiness, and directors' decision making would become more multifaceted, since criteria of stakeholder prioritization would need to be taken into account when making strategic and operational decisions. Most corporations' codes of good practice in corporate governance would need to be revised to be more tightly aligned with the prevailing legal environment. This would include, for example, the recognition that the corporation is the principal to whom the board owes its fiduciary duties and that, legally speaking, the board is not an agent or any party but an autonomous fiduciary of the corporation.

Corporate governance development programs would need to be adapted accordingly to reflect the capabilities needed for effectively balancing competing claims. MBA courses would need to present and engage students with alternative models of understanding agency relationships, rooted in different assumptions and posing a different status and roles for directors. These would enable them to see agency relationships and their role in a different light, perhaps helping to avoid some of the worse failings of shareholder primacy in the future. Further, such education might foster greater cross-cultural sensitivity and understanding, since practice in several countries already operates with a view of the corporation as principal and a view of organizations in terms of multiparty collaborative endeavors rather than as collections of potentially adversarial contracts. Our redefined agency theory may be seen as more applicable and palatable to countries other than those in the Anglo-Saxon world, such as China, Germany, Japan, and Russia, that are more stakeholder oriented and where shareholders are not always treated as primary. Even so, as we have shown, the legal systems in the Anglo-Saxon world also support this approach.

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