FINANCIAL MARKETS AND THE POLITICAL STRUCTURE OF THE ENTERPRISE*

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This paper argues that competitive financial markets disfavor democratic enterprises even assuming such enterprises suffer no allocational deficiencies. This conclusion follows from five assertions: (a) the democratic enterprise requires access to credit markets; (b) access to credit presupposes access to equity markets; (c) the democratic firm's optimal risk level is lower than that desired by stockholders; (d) the risk level assumed by the firm is costly to observe, subject to inaccurate measurement, and contractually unenforceable; and (e) the incentives required to induce stockholder-favorable risk behavior are more costly for democratic firms than for firms with stockholder-accountable management.

1. Introduction

Consider a firm operating in competitive product and factor markets. We use the term 'members' to refer to those involved in the day to day operation of the enterprise as a system of production and we call an enterprise 'democratic', if those holding positions of authority in the enterprise are accountable to its members according to some reasonable notion of political representation. The bulk of economic activity in advanced capitalist economies takes place not in democratic firms, but rather in firms which are externally accountable to creditors and stockholders. How do we account for the prevalence of external accountability in capitalist economies?

Conventional wisdom attributes external accountability to the hierarchical division of labor's incompatibility with participatory decision making, to the worker controlled firm's systematic tendency to misallocate resources [Ward (1958); Furubotn and Pejovich (1970)] and to the inability of democratic firms to control opportunistic worker behavior [Alchian and Demsetz (1972); Williamson (1984)]. Such explanations, however, have both logical and empirical weaknesses.

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First, these arguments confuse the organizational structure of the firm, which deals with the coordination and monitoring of firm members, with its political structure, which deals with the control of those in positions of authority. The democratic enterprise is characterized not by a particular division of labor, but rather by a structure of accountability: that of those in positions of authority to the will of the membership. The democratic enterprise can thus adopt efficient organizational forms without compromising democratic accountability, and can delegate authority to managers to the same extent as do stockholders in externally accountable firms. Second, it can be shown that it is rational for democratic firms to misallocate only when faced with imperfect factor markets: i.e., under circumstances in which the traditional firm would also misallocate [Dow (1986)]. Finally, studies have repeatedly supported the viability of worker control and participatory management.

A compelling explanation of the scarcity of worker-owned firms can be developed on financial grounds. Worker ownership is a pure case of internal finance, while competitive capital markets promote firms dependent predominantly upon external finance, through credit and equity markets. External finance is favored in part because it allows wealth holders an otherwise unavailable degree of risk diversification, and in part because optimal capital intensity generally requires the violation of firms members' wealth constraints. The wealth constraint phenomenon is not operative in a world of Walrasian financial markets, but has considerable force where asymmetric information and agency problems render credit rationing the general rule [Stiglitz and Weiss (1981)]. In this context it can be shown that, under quite general conditions, there is a maximum debt/equity ratio above which credit is unavailable, and below which the interest rate increases with the debt/equity ratio. The worker-owned firm is thus likely to be credit-starved and to suffer excessive costs of debt service in comparison with externally owned firms.

This argument provides an adequate explanation of the absence of workplace democracy, however, only if worker ownership is a precondition of democratic accountability. This assumption, while common in the literature, it is unwarranted: the fact that the enterprise is externally financed

\[^{1}\text{In the context of unfettered financial markets, the benefits of portfolio diversification and economies of scale in production lead individual wealth holders to own small portions of many firms, and dictate that individual firms be owned by many individuals. Free rider problems in owner participation and the specificity of managerial skills then induce owners to delegate control to managers [Fama (1980), Fama and Jensen (1983)]. These conditions apply as well to the democratic firm, and induce members to opt for managerial control.}\]


\[^{3}\text{The following is a summary of arguments presented more fully in Gintis (1988).}\]

\[^{4}\text{Access to external financial markets in the context of the democratic enterprise has been discussed, however, by McCain (1977), Gui (1985), Putterman (1987) and Nuti (1987).}\]
through credit and equity markets does not logically imply that the enterprise is externally accountable to its creditors and stockholders. Indeed, in a Walrasian world the externally financed democratic firm would attract equity capital in precisely the same way such a firm competes on product markets: members would be compelled to choose managers, and to adjust wages, productivity, expected returns, and risk so as to attract equity on a par with the firm’s competitors. The explanation of the absence of widespread worker ownership thus does not extend to an explanation of the limited success of democratic firms.

We may then take the following as assumptions for our analysis that (a) in a competitive environment a democratic enterprise must have access to external finance on the same terms as its competitors; (b) to obtain credit at competitive interest rates, the democratic firm must have an equity base comparable to that of its competitors; and (c) the allocation of resources within the enterprise is independent of the firm’s political constitution.5 I shall suggest that, despite its ability otherwise to compete successfully in product markets, the externally financed democratic firm will in general lack competitive access to equity markets.

The general argument may be framed as follows. Stockholders prefer a higher level of risk than do firm members. For since members are not residual claimants, they are not concerned with the ‘upper tail’ of the distribution of returns, but rather act to preserve the continuance of employment, and hence to avoid bankruptcy.6 By contrast stockholders, who stand to benefit from windfall gains, are willing to tolerate a strategy incurring a higher risk of failure. In addition, the risk level assumed by the firm is costly to observe, subject to inaccurate measurement, and contractually unenforceable.7 Were the firm’s strategy towards risk publicly observable, competitive pressures would induce the democratic firm to match the risk behavior of other firms. But in the absence of public observability, stockholders must offer costly incentives to induce the firm to choose acceptable risk levels. Stockholders then prefer that managers not be subject to democratic control on the following grounds: in a democratic setting, the

5Democracy and capitalism [Bowles and Gintis (1986)] argues that the democratic firm should enjoy allocational superiority through its ability to curb shirking and lower monitoring costs. Adding productivity differences to the present model, however, is an unnecessary complication.

6We assume throughout that job loss is a disciplining device, and hence firm members enjoy rents associated with employment, including firm-specific human capital, work incentives, and ‘enforcement rents’ which render the firm’s threat of dismissal effective [Gintis (1976); Shapiro and Stiglitz (1984); Bowles (1985); Bowles and Gintis (1988)].

7Risk level is difficult to observe because it is revealed only through the statistical behavior of profits through time. Thus excessively risky behavior (always the fear of creditors) is only revealed ex post through the firm’s failure. Insufficient risk-taking, on the other hand, can be ascertained only over many observational periods. Moreover, even in case of failure, it is difficult to distinguish between poor risk management and simple bad luck.
inducements that stockholders must offer managers to choose an appropriate risk level (profit sharing, stock options, or partial ownership), must be extended at least to a majority of the members of a democratic firm; in a managerially controlled firm, by contrast, these inducements may be limited to managers alone. Thus external accountability is more cost effective for stockholders.³

This analysis, while concluding that unfettered financial markets disfavor the democratic enterprise on distributional rather than allocational grounds, should not be viewed as a blanket indictment of competition in financial markets. While there is no general Walrasian argument asserting the Pareto-efficiency of the market-determined level of risk in a purely competitive economy, the risk behavior favored by unfettered financial markets may be justified by a Schumpeterian argument attributing superior dynamic performance to economics fostering rapid innovation. In this view, the democratic enterprise would be considered excessively conservative. This paper thus raises the challenge of devising mechanisms of financial allocation preserving the benefits of unfettered financial markets without their anti-democratic bias [McCain (1977); Nuti (1987)].

2. Residual claimancy and risk taking behavior

To focus upon the availability of equity finance, we assume all firms have the same level of debt, face common product and factor prices, and have the same production possibilities set, on the frontier of which they operate. The economic actors consist of firm’s members and stockholders who own equity in the firm. Members earn a wage w and are guaranteed reemployment unless the firm fails. The wage is assumed to be paid with certainty, but the revenues of the firm may be insufficient to service the debt D. In this case the firm is dissolved, creditors receive the firm’s liquidation value, and members become unemployed – a fallback position having present value z. In case of success, stockholders are the residual claimant.⁹¹⁰

The firm’s sole choice variable is the level of risk x. The revenue of the firm, net of all costs except debt service, is x + φ(x), where x is a random variable of zero mean, and φ(x) is the expected value of net revenue. The density f(x, z) and cumulative distribution F(x, z) of x thus depend on the

³Of course the democratic firm will also have managers who must be controlled by supervision and incentives. The point is that members will choose different incentives for their managers than will stockholders. In a democratic firm members will have to be bribed to offer managers incentives favorable to stockholders [This argument is generalized in Gintis, forthcoming, and Bowles and Gintis (1988)].

⁹The members’ fallback z is a function of such factors as the expected duration of unemployment, the expected wage at alternative employment, and the level of unemployment insurance [Bowles (1986); Gintis and Ishikawa (1987)]. We treat z as exogenous.

¹⁰A list of symbols to which the reader may refer follows the Appendix.
risk level \( x \). We take \( x \) as defined on the interval \([-1, \infty)\), with mean zero, higher \( x \) representing a riskier investment.\(^{11}\) We assume expected return increases with risk, so \( \phi_x \geq 0 \), and the choice of \( x \) is neither observable nor contractually enforceable by the firm's outside owners and creditors.

Let \( u \) represent the present value of being employed. Since a member earns wage \( w \) and has the fallback asset position \( z \) in case of bankruptcy, writing \( p(x) \) for the probability of bankruptcy at risk level \( x \), we have

\[
v(x) = \left[ w + p(x)z + (1 - p(x))v(x) \right] / (1 + \rho) \]

\[
= \left[ w + p(x)z \right] / q(x),
\]

where \( \rho \) is the discount rate and \( q(x) = p(x) + \rho \).

Let \( s(x) \) be the present value of the firm's stock. If \( S(x) \) is the expected value of a successful investment, then an investor receives \( S(x) - D \) with probability \( 1 - p(x) \), and holds a worthless security with probability \( p \). Thus

\[
s(x) = (1 - p(x))(S(x) - D) / (1 + \rho)
\]

\[
= \left[ 1 - p(x) \right] [S(x) - D] / q(x).
\]

We assume that all agents maximize the expected present values of their holdings.\(^{12}\) We then have the following first order conditions with respect to the risk parameter \( x \), where the cost \( w^* \) of losing a job is defined as \( w^* = (w - \rho z) \):\(^{13}\)

\[
v_x = -w^* p_x / q^2,
\]

\[
s_x = [q(1 - p)S_x - (1 + \rho)(S - D)p_x] / q^2.
\]

We, assuming the cost of job loss is positive, we can then show (proofs are in the appendix):

**Proposition 1.** An externally financed democratic enterprise, minimizes the probability of bankruptcy. Stockholders strictly prefer a higher level of risk.

\(^{11}\)The parameter \( x \) represents increasing risk in the sense that the mean-preserving distribution \( F(x, z) \) has more weight in its tails for higher \( x \) [Rothschild and Stiglitz (1970)]. A precise formulation is given below. We assume the support of \( f(x, z) \) is compact, and its first and second derivatives of \( f \) with respect to \( x \) are continuous and bounded.

\(^{12}\)This assumption is plausible in the case of wealth holders, who can diversify. Risk aversion on the part of members would doubtless strengthen the argument, but without adding additional insights.

\(^{13}\)Here and throughout, a variable subscript represents the partial derivative with respect to that variable.
If, however, firm members have some shares of their own stocks, outside stockholders will be better off. Suppose members in a firm hold $\tau$ shares of stock per unit of labor. Then calling $\tau$ the 'degree of member ownership' we have

**Proposition 2.** The level of risk chosen by a democratic firm increases with the degree of member ownership. Among democratic firms, outside stockholders strictly prefer those with the highest degree of member ownership.

Equations (1) and (3) show that a proportional increase in $w^*$ and $\tau$ leaves the equilibrium level of risk unchanged. Hence an increase in $w^*$ has the same effect on $\alpha$ as a decline in $\tau$. From this follows the

**Corollary.** In democratic firm with a positive level of member ownership, a decline in the cost of job loss entails a rise in the members' optimum level of risk. As the cost of job loss falls, outside investors become increasingly tolerant of democratic firms.

Clearly stockholders would prefer to choose the level of risk rather than leaving this choice to firm members. If members make this choice, however, it may be in stockholders' interest to offer members part ownership in order to influence their choice of risk level: to the extent that members are residual claimants, their decisions will then reflect the interests of stockholders. Indeed, if the cost of job loss is sufficiently low, we have

**Proposition 3.** In a purely externally financed democratic firm, it is in the stockholders' interest to initiate a one-way transfer of stock to firm members to influence their risk behavior. The greater the cost of job loss to members, the larger the transfer required to achieve a given risk level, and the smaller the optimal transfer.

It is not surprising that the effectiveness of partial member ownership in this respect varies inversely with the cost of job loss to members. For members will choose a level of risk which balances the cost of job loss in case of bankruptcy against the gains associated with their share of the profits in case of success. Where labor markets are tight and there is little firm-specific human capital, the democratically controlled firm can thus be induced to reflect the interests of owners at little cost; where the cost of job loss to members is considerable, however, the cost of inducing decision-makers to reflect stockholders' interests will be corresponding high.
The assertion that if owners must delegate control, they will prefer external to democratic accountability, now follows directly from Proposition 3. For if it is profitable for owners to transfer stock to the members, it is clearly more profitable, and equally effective, to transfer stock to a single manager.¹⁴

3. Conclusion

Our analysis may strike the reader as a mere gloss on the venerable argument that the democratic firm allocates risk inefficiently because it does not maximize the profits, and is shunned by competitive financial markets because it is inefficient. It is true that Arrow-Debreu economies with complete asset markets efficiently allocate risk. When asset markets are incomplete, however, even those assets which are present in the economy are inefficiently allocated [Geanakoplos and Polemarchakis (1986)]. Equity markets, in particular, are in general Pareto inefficient [Stiglitz (1982)], and traditional firms do not efficiently allocate risk. Whence the need for the more delicate analysis presented in this paper.

Wealth holders do not choose to invest in democratic firms, this analysis suggests, because firm members and owners have different interests in the choice of risk level. Owners can induce the firm to reflect their interests as residual claimants more effectively by directing their incentives to a small group of managers unaccountable to the firm's membership, rather than by distributing these incentives to the membership.

One presumes that a democratic society will favor social policy measures expanding the range of democratic participation in the economy, provided that such measures do not unduly conflict with its standards of liberty, efficiency, equity, innovation, and growth. It would of course be a mistake to infer from our argument that such policy should simply circumvent competitive financial markets in providing democratic firms with guaranteed sources of finance. Even rendering the renewal of credit contingent upon the firm's performance is inadequate, since policy makers are (at best) no more adept at assessing the firm's risk behavior than are stockholders.

A more auspicious policy involves using taxes, subsidies and regulation to overcome the financial advantages of the traditional firm. Among the effects of such a policy, we have seen, would be an aggregate reduction in risk-taking in the productive sectors of the economy. This reduction, while not necessarily Pareto inefficient, may conflict with long-term goals of growth and innovation. Competitive markets produce suboptimal levels of inno-

¹⁴This result is a special case of a more general 'principle of external accountability' asserting that under fairly general conditions competitive financial markets are hostile to democratic organization for distributive rather allocative reasons (Gintis, forthcoming).
vation [Arrow (1962)]. But given the risks involved, democratic firms may be even less willing to innovate than capitalist firms.\footnote{Innovation will also be resisted by members because successful innovation may involve the obsolescence of technology-specific skills serving as an important source of labor income. Since such human capital is a form of social wealth, however, no misallocation results from its being factored into the innovation decision.}

Ultimately, then, the policies most successful in promoting the democratic enterprise may follow the traditional strategy of locating and repairing market failures – in this case by addressing the 'imperfections' in labor and capital markets which account for the traditional firm's favored treatment by financial markets.

The offending labor market imperfection involves the fact that work intensity/quality cannot be contractually enforced. The contested character of work quality gives rise to unemployed labor resources and an excessive cost of job loss in equilibrium. The high cost of job loss, we have seen, in turn strengthens the democratic firm's conservative tendencies. This imperfection also prevents workers from insuring themselves against fluctuations in labor income. For on the one hand employers would not knowingly engage a worker fully ensured against job loss, since the threat of job loss would then be inoperative. On the other hand, potential insurers face considerable moral hazard in underwriting labor income.

Given this imperfection, public policy in capitalist economies has stepped in to provide employment insurance. A vigorous policy of maintaining tight labor markets, extending unemployment compensation, as well as providing job retraining and lifetime learning opportunities to workers, is thus likely to serve as a key element in rendering the democratic enterprise competitive and socially efficient.

The offending capital market imperfection lies in the impossibility of contractually specifying the risk behavior of managers of financial resources. This imperfection gives rise to capital rationing in which access to financial resources is predicated upon an agents' possessing a sufficient equity position in their investments. This requirement imposes strict bounds on the access to credit by individuals, and hence limits the ability of firm members as a group to acquire a significant level of equity in their firms. Yet as we have seen, a significant level of member ownership improves a democratic firm's position vis-a-vis passive investors, and hence vis-a-vis banks and other creditors, while at the same time raising the firm's optimal risk level. This line of reasoning suggests that public policy provide a source of credit to individuals tied to participation in the democratic enterprise.

Appendix

We shall begin the proofs by deriving the second order conditions and
some comparative static properties associated with (3) in the text. The second partials of (3) given by

\[ v_{xx} = \left[ w^* \rho_{xx} + 2q^2 v_x \right]/q^2 = w^* \left[ 2p_x^3 - q \rho_{xx} \right]/q^3, \]

\[ s_{xx} = -2(S_x + s_x)p_x/q + (1 - p)S_{xx}/q - (1 + p)(S - D)p_{xx}/q^2 \]

\[ = -2S_x p_x (1 + p)/q^2 + (1 - p)S_{xx}/q + (1 + p)(S - D)(2p_x^3 - q \rho_{xx})/q^3. \]  

(A.1)

Now let \( x = y + \phi(x) \) where \( y \) is a random variable of zero mean whose density \( f(y, x) \) is non-zero on a bounded subinterval of \([-1, \infty)\), where \( f(y, x) \) is riskier for larger \( x \). If \( p(x) \) is the probability of failure, we have

\[ p = Pr\{x < D\} = Pr\{y < D - \phi(x)\}, \]

from which we derive

\[ p_x = F_x(D - \phi, x) - \phi_x(x) f(D - \phi(x), x). \]  

(A.3)

Moreover, if we define

\[ \eta(x) = \int_{-1}^{D - \phi} y \, dF, \]

then \((1 - p)S = \int_{-1}^{D - \phi} x \, dF = \phi(1 - p) - \eta\). Hence

\[ S(x) = \phi(x) - \eta(x)/(1 - p(x)). \]  

(A.4)

From the definition of \( \eta \), we have

\[ \eta_x = -\phi_x(D - \phi) f(D - \phi) + \int_{-1}^{D - \phi} y \, dF_x \]

\[ = -\phi_x(D - \phi) f(D - \phi) + (D - \phi) F_x - R \]

\[ = (D - \phi)[F_x(D - \phi) - \phi_x f(D - \phi)] - R, \]

where we have defined \( R = \int_{-1}^{D - \phi} F_x \, dy \). Thus we have

\[ \eta_x = (D - \phi)p_x - R. \]  

(A.5)

\[ R > 0. \]
Here the inequality $R > 0$ follows from the definition of increasing risk [Rothschild and Stiglitz (1970)].

Now (A.4) and (A.5) imply $S_z = [\phi_z (1-p) + R + p_z (S - D)]/(1-p)$.

Finally, from (A.1) we have

$$q^2 s_z = q [(1-p) \phi_z + R - p_z (1-p) (S - D)]$$

Proof of Proposition 1. From (3) we have $v_z = -w* p_z / q^2 = 0$, which implies $p_z = 0$. The second order condition (A.2) implies $p_{zz} > 0$. Hence the probability of failure is a local minimum at a worker equilibrium.

From (3), a worker optimum we have $s_z = q (1-p) S_z / q^2$. Thus to prove the second part of Proposition 1, we need only show that $S_z > 0$ at a worker optimum. But from (A.6), $s_z = [(1-p) \phi_z + R]$, where $R = \int t^* F_z (y, z) dy$. Now $\phi_z$ is positive since net revenue is an increasing function of risk; moreover, $R$ is positive by the definition of increasing risk. Hence $s_z$ is positive, implying $S_z > 0$ at a worker optimum.

Proof of Proposition 2. A worker with $T$ shares of stock has objective function $u = v + \tau s$. The first order condition for a maximum is then $u_z = v_z + \tau s_z = 0$. Differentiating totally with respect to $\tau$, we find $s_z = -u_{zz} \tau_z$. Let $S = \{ \tau \geq 0 | \tau_z > 0 \}$. We shall show that $S$ is non-empty, open, and closed in the positive half-line. Hence it coincides with the positive half-line.

We have $\tau = 0$, $p(\tau) = 0$, so $s_z > 0$, implying $\tau_z > 0$. Thus $S$ is non-empty. $S$ is open since $u(\tau)$ is continuous. To show that $S$ is closed, suppose $\{ \tau_i \}$ is a sequence in $S$ with limit $\tau$, and $\tau$ is not in $S$. Then by continuity we have $\tau_z = 0$, so $s_z = 0$ by (1). Then the first order conditions require $v_z = 0$. But we have already shown in Proposition 1 that $v_z = 0$ implies $s_z > 0$. This is a contradiction.

Thus $\tau_z > 0$ for $\tau > 0$. Since $u_{zz} < 0$ by the second order condition, $s_z = -u_{zz} \tau_z$ implies $s_z > 0$ for all $\tau$, which in turn implies that outside stockholders prefer firms with a higher degree of worker ownership. This proves Proposition 2.

Proof of Proposition 3. Suppose stockholders transfer a proportion $\varepsilon$ of their securities to workers. Then their present value is $u = (1-\varepsilon) s$. Differentiating, we find $u_\varepsilon = (1-\varepsilon) s \tau \tau - s$. The optimal risk must satisfy the first order condition $u_\varepsilon = v_\varepsilon + \varepsilon s_\varepsilon = 0$. The derivative of this expression gives $\tau \varepsilon = -s_\varepsilon / u_{zz}$. At $\varepsilon = 0$ we have $p_\varepsilon = 0$, so (A.5) shows that $\tau \varepsilon = (1-p) S \tau q / w* p_*$. This expression is positive, and becomes arbitrarily large as $w*$ approaches zero. Hence for sufficiently small $w*$, $u_\varepsilon > 0$ for $\varepsilon = 0$. Thus it is rational for stockholders to transfer some wealth to workers.

Now assume there is a stockholder optimum at risk level $\varepsilon$ with stock transfer $\varepsilon > 0$ for a given $w*$. Since $\varepsilon$ is the solution to the firm's maximiza-
tion of \( u = v + \varepsilon s \), \( v_z + rs = 0 \). Since \( v_z = -w^*p_z/q^2 \), it is clear that an increase in \( w^* \) matched by a proportional increase in the stock transfer \( \varepsilon \) will leave the level of risk unchanged. Thus a greater cost of job loss requires a larger stock transfer to achieve a given level of risk. This proves Proposition 3.

**List of Symbols**

- \( D \): debt burden of the firm
- \( f(x, z) \): density of \( x \) for risk level \( z \)
- \( F(x, z) \): distribution of \( x \) for risk level \( z \)
- \( p(x) \): probability of bankruptcy for risk level \( z \)
- \( q(x) = p(x) + \rho \)
- \( s(x) \): present value of a pure stock
- \( S(x) \): expected value of the investment upon success
- \( x \): stochastic component of the firm's revenue
- \( u \): present value of a security
- \( v \): present value of being employed
- \( w^* = w - \rho z \): (cost of job loss to firm member)
- \( w \): wage rate
- \( z \): fallback position of a firm member
- \( x \): risk level chosen by firm
- \( \tau \): degree of member ownership of the firm
- \( \phi(x) \): expected value of the firm's revenue for risk level \( x \)
- \( \rho \): discount rate

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