



CHAPMAN LAW REVIEW

Citation: Sung Eun (Summer) Kim, *Dynamic Corporate Residual Claimants: A Multicriteria Assessment*, 25 CHAP. L. REV. 67 (2021).

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Dynamic Corporate Residual Claimants: A Multicriteria Assessment

*Sung Eun (Summer) Kim**

Corporate law provides residual claimants with key legal protections and rights, including fiduciary duty protections and voting rights. Under the conventional corporate law framework, shareholders are seen as the residual claimants of corporations because they are the parties who receive the residual profits of the corporation. This profit-oriented view of residual claimancy, however, is incomplete because it considers only one of the multiple criteria that are relevant to residual claimant analysis. In addition to profits, various other criteria have been used to identify the residual claimant of corporations over time, such as the variability of rewards, the wealth effects of one's decisions, firm-specific investments, risk of loss, and monitoring capacities. The decision to rely on a single criterion (profit) to determine that shareholders are the exclusive residual claimants of corporations is, then, a policy choice that preferences one dimension of residual claimancy over others. This policy choice has had a profound impact on how corporate power and value are distributed in our society. This Article outlines a multicriteria assessment of corporate residual claimants which contemplates a more diverse conception of the residual claim and that could be used to broaden the group of stakeholders that are entitled to enjoy residual claimant protections and rights.

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INTRODUCTION.....	69
I. CORPORATE RESIDUAL CLAIMANTS: A SINGLE-CRITERION APPROACH	73
A. Single-Criterion Residual Claimancy and Shareholder Primacy.....	74
B. Challenging Residual Claimancy as a Rationale for Shareholder Primacy.....	75
II. CORPORATE RESIDUAL CLAIMANTS: A MULTICRITERIA ASSESSMENT	76
A. A Multicriteria Assessment of Corporate Residual Claimants: The Criteria	77
1. Order of Payment	77
2. Variability of Reward.....	78
3. Wealth Effect of Own Decisions	80
4. Firm-specific Investments	81
5. Protection Against Non-payment.....	81
6. Undiversified Risks	82
7. Bargaining Power.....	83
8. Express and Implied Contracts	84
9. Monitoring Capacity.....	85
B. A Multicriteria Assessment of the Shareholder's Residual Claim	85
III. ACKNOWLEDGING THE DYNAMIC NATURE OF CORPORATE RESIDUAL CLAIMS	87
A. The Dynamic Nature of Corporate Residual Claims	88
1. Multiple Residual Claimants.....	88
2. The Heterogeneity Problem.....	89
3. Mixed Residual Claimants.....	90
4. Shifting and Temporary Residual Claimants.....	91
5. Unknown Residual Claimants.....	91
B. Using a Multicriteria Assessment to Evaluate Corporate Residual Claims.....	92
1. Multicriteria Assessment and the Stakeholder Model.....	92
2. Choice Among Criteria.....	93
CONCLUSION.....	95

INTRODUCTION

The identity of the residual claimant has important legal consequences within the corporation. Delaware law provides that directors have a fiduciary duty to strive to maximize value for the benefit of the residual claimants,¹ and corporate law scholars have suggested that the right to vote in corporations should follow the residual claim.²

In recent decades, the dominant understanding in corporate law has been that shareholders are the sole residual claimants of corporations³ and thus the holder of various residual claimant rights and protections. In this way, residual claimant theory has been a rationale for the shareholder primacy norm in corporate law.⁴

In this Article, I argue that this conventional view that shareholders are the sole residual claimants of corporations is incomplete because it relies on only one (residual profit) among the multiple criteria that are relevant to residual claimant analysis.

A review of the literature reveals that there are at least nine considerations that have shaped our understanding of the residual claimant over time. They include: (i) the order of payment, (ii) the variability of reward, (iii) the wealth effects of one's own decisions, (iv) firm-specific investments, (v) recourse, (vi) undiversified risk, (vii) bargaining power, (viii) contracts, and (ix) monitoring capacities. The main contribution of this Article is the presentation of a multicriteria assessment of corporate residual claimants that considers these multiple dimensions of the residual claim.

In a companion paper, I trace the history of residual claimant theory to show how a variety of corporate stakeholders have been considered to be the residual claimants of corporations over time.⁵

¹ See, e.g., *Frederick Hsu Living Tr. v. ODN Holding Corp.*, No. C.A. 12108–VCL, 2017 WL 1437308, at *20 (Del. Ch. Apr. 24, 2017) (referring to directors' fiduciary duty to "strive to maximize value for the benefit of the residual claimants"); *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 20 (Del. Ch. 2013) ("Directors of a Delaware corporation owe fiduciary duties to the corporation and its stockholders which require that they strive prudently and in good faith to maximize the value of the corporation for the benefit of its residual claimants.").

² Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 404 ("The right to vote . . . follows the residual claim.").

³ See, e.g., ROBERT C. CLARK, *CORPORATE LAW* 18 (Francis A. Allen et al. eds., 1986) ("[I]t is the shareholders who have the claim on the residual value of the enterprise, that is, what's left after all definite obligations are satisfied . . .").

⁴ See, e.g., Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 175 (1989) ("[S]hareholders retain plenary authority to guide the fate of a corporate enterprise because . . . they have the greatest stake in the outcome of corporate decision-making . . .").

⁵ See generally Sung Eun ("Summer") Kim, *Tracing the Diverse History of Corporate Residual Claimants*, 95 S. CAL. L. REV. POSTSCRIPT 43 (2022).

Depending on which of the theories of residual claimancy (rent, interest, wages, or profit) was adopted, the landlord, capitalist, laborer, or entrepreneur, respectively, has been considered the residual claimant of the corporation.⁶ This review reveals that the conventional understanding that shareholders are the residual claimants of corporations is a relatively recent understanding and that the historical record supports a more diverse and evolving conception of the residual claimant.

A multicriteria assessment of corporate residual claimants is likely to produce results that depart from the theoretical ideal of a single and unchanging residual claimant that is often assumed in the academic literature. For example, Armen Alchian and Harold Demsetz describe the classical capitalist firm as a firm with *one* central-common party who is the residual claimant.⁷ Eugene Fama and Michael Jensen have also emphasized that having a *single* group of residual claimants adds to the survival value of an organization.⁸

Although treating one group of stakeholders as the sole residual claimants of corporations has the benefit of uniformity and consistency, thus lowering transaction costs,⁹ these cost savings must be balanced against the costs that stem from the failure to recognize the residual claims held by other corporate stakeholders. The multicriteria assessment of corporate residual claimants outlined in this Article provides an analytical framework that can be used to engage in these tradeoffs.

The present moment is a timely one in which to recognize the limits of the single-criterion (profit-residual) view of residual claimants, and the attendant treatment of shareholders as the

⁶ *Id.*

⁷ Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 783 (1972). The essence of the classical firm is a contractual structure with:

(a) joint input production, (b) several input owners, (c) *one party* who is common to all the contracts of the joint inputs, (d) who has rights to renegotiate any input's contract independently of contracts with other input owners, (e) *who holds the residual claim*, and (f) who has the right to sell his central contractual residual status.

Id. (emphasis added). But they also note that “[p]rofit sharing [i.e., sharing of the residual claimant status] to encourage self-policing is more appropriate for small teams.” *Id.* at 786.

⁸ Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 303 (1983) (“Having most uncertainty borne by one group of agents, residual claimants, has survival value because it reduces the costs incurred to monitor contracts with other groups of agents and to adjust contracts for the changing risks borne by other agents.”).

⁹ The view of the firm as a transaction cost mitigation device begins with Ronald H. Coase’s article, *The Nature of the Firm*, and is continued by Oliver E. Williamson in *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS*. Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937); OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (Free Press 1975).

exclusive holders of various residual claimant privileges and rights within corporations. A number of recent examples show how preferencing shareholders' interests can come into tension with human rights,¹⁰ workers' rights,¹¹ environmental sustainability,¹² and consumers' well-being.¹³ Some have argued that the 2007–2009 global financial crisis was triggered by aligning bank policy with the interest of banks' shareholders, who had a penchant for excessive risks.¹⁴ Also, multiple accounts point to how executive compensation schemes seeking to align managerial and shareholder interests tend to incentivize managers to artificially inflate the financial performance of the firms they manage.¹⁵ In the context of the banking industry, Lucian Bebchuk and Holger Spamann have explained how stock-based executive pay has led to excessive risk-taking and underestimating the downside of these risky strategies.¹⁶

¹⁰ See, e.g., Sui-Lee Wee, *China Uses DNA to Track Its People, With the Help of American Expertise*, N.Y. TIMES (Feb. 21, 2019), <http://www.nytimes.com/2019/02/21/business/china-xinjiang-ughur-dna-thermo-fisher.html> [<http://perma.cc/46C6-2C7A>] (describing how Thermo Fisher's equipment was used to analyze DNA samples of Chinese people in Xinjiang, China; however, the company ultimately voluntarily withdrew from the market citing its "values, ethics code and policies").

¹¹ See, e.g., Ken Jacobs et al., *Living Wage Policies and Big-Box Retail: How a Higher Wage Standard Would Impact Walmart Workers and Shoppers*, U.C. BERKELEY CTR. FOR LAB. RSCH. & EDUC. 1–2 (Apr. 2011), http://laborcenter.berkeley.edu/pdf/2011/bigbox_livingwage_policies11.pdf [<http://perma.cc/4MXV-GYZE>].

¹² See, e.g., EPA, *California Notify Volkswagen of Clean Air Act Violations*, CAL. AIR RES. BD. (Sept. 18, 2015), <http://ww2.arb.ca.gov/news/epa-california-notify-volkswagen-clean-air-act-violations> [<http://perma.cc/7CRE-9BK6>].

¹³ See, e.g., David G. Yosifon, *The Consumer Interest in Corporate Law*, 43 U.C. DAVIS L. REV. 253, 266–67 (2009); Sung Eun ("Summer") Kim, *Consumer Primacy: A Dynamic Model of Corporate Governance for Consumer-Centric Businesses*, 2022 UTAH. L. REV. 1, 3–4 (2022) (highlighting the harmful consequences of a misalignment between profit and consumer welfare).

¹⁴ See Frank Jan De Graaf & Cynthia A. Williams, *The Intellectual Foundations of the Global Financial Crisis: Analysis and Proposals for Reform*, reprinted in THE EMBEDDED FIRM: CORPORATE GOVERNANCE, LABOR, AND FINANCE CAPITALISM 383, 383, 400 (Cynthia A. Williams & Peer Zumbansen eds., 2011); see also Leo E. Strine Jr., Vice Chancellor, Del. Ch., Keynote Speech at the Molengraff Institute for Private Law: Governance of the Modern Firm: The Role of Delaware in the American Corporate Governance System, and Some Preliminary Musings on the Meltdown's Implications for Corporate Law 1, 1–2 (Dec. 13, 2008) (transcript available at <http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.26854.11.pdf> [<http://perma.cc/879J-L9K2>]) ("Precisely because corporate law goads directors to create wealth for their stockholders, and gives stockholders increasingly potent tools to hold directors accountable for failing to produce profits, it creates a stimulus for risk-taking up to the bounds of positive law.").

¹⁵ See, e.g., Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSPS. 71, 88–89 (2003).

¹⁶ Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 247 (2010) ("Because bank executives expect to share in any gains that might flow to common shareholders, but are insulated from losses that the realization of risks could impose on preferred shareholders, bondholders, depositors, and taxpayers, executives have incentives to give insufficient weight to the downside of risky strategies.").

There are many reasons to expect a turn in the tide. They include the emergence of business models that prioritize privacy over profits,¹⁷ that emphasize consciousness,¹⁸ and that seek shared value rather than shareholder value.¹⁹ These trends have incubated new organizational forms that state public benefit as their business purpose.²⁰ The COVID-19 global public health crisis has prompted us to reevaluate our values and priorities, including a shift from efficiency to resiliency.²¹ The digital transformation has resulted in the mass extinction and mass speciation of innovative entities with entirely new DNA in the corporate world.²² Decentralized autonomous organizations (DAOs) that are built on smart contracts to automate and democratize governance are one example of this innovation.²³ These changes all suggest that a time of reckoning has come for the corporate law paradigm that looks only to profits as the measure of corporate value and to shareholders as the sole residual claimants of corporations.

A multicriteria assessment of corporate residual claimants offers a foundation for a more diverse conception of the residual claimant that considers the interests and contributions of multiple corporate stakeholders. While recognizing multiple residual claimant interests will necessarily increase the complexity of residual claimant analysis, it is more aligned with

¹⁷ See, e.g., *LunaDNA Is Approved by the SEC to Offer Ownership Shares to Individuals for Sharing Data*, LUNADNA (Apr. 19, 2019), <http://www.lunadna.com/ownership-shares-for-sharing-data-2/> [<http://perma.cc/U5KF-LFS4>] (describing a business structure which prioritizes users' privacy rights by providing ownership rights to the users who contribute data to the platform).

¹⁸ See JOHN MACKEY & RAJ SISODIA, *CONSCIOUS CAPITALISM: LIBERATING THE HEROIC SPIRIT OF BUSINESS* 25–40 (Harv. Bus. Rev. Press 2013).

¹⁹ See Michael E. Porter & Mark R. Kramer, *Creating Shared Value*, HARV. BUS. REV., Jan.–Feb. 2011, at 62, 64.

²⁰ See, e.g., DEL. CODE ANN. tit. 8, § 362(a) (2015) (creating a benefit corporation form, which is a for-profit corporate form “intended to produce a public benefit or public benefits and to operate in a responsible and sustainable manner”).

²¹ Martin Gelter & Julia M. Puauschunder, *COVID-19 and Comparative Corporate Governance*, 46 J. CORP. L. 557, 577–622 (2021) (discussing three key COVID-19 trends in corporate governance: turning from “efficient” to resilient structures, greater nationalism, and a resurgence of stakeholder models); see also Arden Rowell, *COVID-19 and Environmental Law*, 50 ENV'T L. REP. 10881, 10881 (2020) (discussing changes in behavior, demographics, values, and resources regarding approaches to environmental considerations triggered by the COVID-19 pandemic); Khalil Jebran & Shihua Chen, *Can We Learn Lessons from the Past? COVID-19 Crisis and Corporate Governance Responses*, INT'L J. FIN. & ECON. (forthcoming 2021), available at <http://onlinelibrary.wiley.com/doi/epdf/10.1002/ijfe.2428> [<http://perma.cc/N29A-325X>] (comparing different corporate governance models and their effectiveness in responding to crises such as the COVID-19 pandemic, and emphasizing the need for organizations to consider both internal and external environments).

²² See THOMAS M. SIEBEL, *DIGITAL TRANSFORMATION: SURVIVE AND THRIVE IN AN ERA OF MASS EXTINCTION* 11–30 (RosettaBooks eds. 2019).

²³ See *Decentralized Autonomous Organizations (DAOs)*, ETHEREUM, <http://ethereum.org/en/dao/> [<http://perma.cc/XR5G-Z26K>] (last visited Apr. 14, 2022).

the recent shift in corporate purpose from shareholder primacy to stakeholder capitalism.²⁴

The balance of this Article will proceed as follows: Part I examines the prevailing view of shareholders as residual claimants in corporate law, which has been foundationally shaped by what I refer to as a single-criterion profit-residual analysis of residual claimancy. Drawing from these foundations, the consensus has been that the residual claimant theory generally points to shareholder primacy in corporations. It is this consensus—and the broader implications of this consensus—that this Article responds to and critiques. Part II presents a multicriteria assessment of corporate residual claimants that draws from the multiple identities of the residual claimant that have been used to evaluate residual claimancy in the academic literature. By analyzing the common shareholder of a large, open corporation under the multicriteria assessment, I show that the common shareholder embodies some but not all of the residual claimant criteria. Part III examines the incompatibility of a fixed (single-criterion) view of residual claimancy with the evolving and multi-faceted nature of corporate residual claims, and describes some applications and extensions of the multicriteria assessment that may be more compatible with this dynamic nature of corporate residual claims.

I. CORPORATE RESIDUAL CLAIMANTS: A SINGLE-CRITERION APPROACH

In this Part, I describe the prevailing view of corporate residual claims, which I refer to as the single-criterion (profit-residual) approach to corporate residual claimant analysis. In

²⁴ See, e.g., Larry Fink, *A Fundamental Reshaping of Finance*, BLACKROCK, <http://www.blackrock.com/hk/en/insights/larry-fink-ceo-letter> [http://perma.cc/E2U2-4MBA] (last visited Jan. 7, 2021) (“[A] company cannot achieve long-term profits without embracing purpose and considering the needs of a broad range of stakeholders.”); *Business Roundtable Redefines the Purpose of a Corporation to Promote “An Economy That Serves All Americans,”* BUS. ROUNDTABLE (Aug. 19, 2019), <http://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans> [http://perma.cc/EV5X-QRSX] (“Business Roundtable . . . announced the release of a new Statement on the Purpose of a Corporation signed by 181 CEOs who commit to lead their companies for the benefit of all stakeholders—customers, employees, suppliers, communities and shareholders.”); Rusty O’Kelley & Anthony Goodman, *2020 Global and Regional Corporate Governance Trends*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 18, 2020), <http://corpgov.law.harvard.edu/2020/01/18/2020-global-and-regional-corporate-governance-trends/> [http://perma.cc/D4M4-C9XB] (“A shift in corporate purpose from shareholder primacy to stakeholder capitalism i[s] underway, reinforced by the US Business Roundtable’s Statement on the Purpose of a Corporation.”). *But see* Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 109 CORNELL L. REV. 91, 164–75 (2020) (critically examining and rejecting “stakeholderism” on the basis that it insulates corporate leaders).

Section A, I discuss how the single-criterion (profit-residual) approach to residual claimant analysis transformed residual claimant theory into a rationale for the shareholder primacy norm in corporate law. In Section B, I discuss the critiques and gradual erosion of residual claimant theory as a rationale for the shareholder primacy norm.

A. Single-Criterion Residual Claimancy and Shareholder Primacy

The modern legal conception of corporate residual claimants has been shaped by a law and economics analysis that attaches residual claimant status to the owners of the residual rights to the corporation's profits. The classic example is Frank Easterbrook and Daniel Fischel's work, which describes shareholders as the sole residual claimants of firms, relying on an implicit contract that entitles shareholders to all of the profits that remain after other claimants' claims have been satisfied.²⁵ The shareholders' presumed exclusive status as residual claimants has been used to justify shareholder voting, including the "one share, one vote" rule,²⁶ and to explain why corporate fiduciary duties of care and loyalty should generally run only to the shareholders.²⁷

While the Delaware corporation statute does not explicitly state that the purpose of the business corporation is to maximize shareholder profits, a long line of precedents points in this direction, often using shareholders' residual claimant status as their justification. As explained by Stephen Bainbridge, Delaware corporate law precedents state that "the principal obligation of corporate directors is to increase the value of the residual claim—namely, to increase shareholder wealth."²⁸ In 2010, the Delaware Chancery Court affirmatively made it difficult for for-profit corporations to pursue broader stakeholder interests at the expense of shareholder interests in realizing a return on their investments.²⁹

²⁵ FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 36–37 (Harv. Univ. Press 1991) [hereinafter *ECONOMIC STRUCTURE*].

²⁶ *Id.* at 73 ("Votes follow the residual interest in the firm, and unless each element of the residual interest carries an equal voting right, there will be a needless agency cost of management."); *see also* Easterbrook & Fischel, *supra* note 2.

²⁷ *See* sources cited *supra* note 1.

²⁸ Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 *UCLA L. REV.* 601, 605 (2006) ("According to a significant line of corporate precedents, the principal obligation of corporate directors is to increase the value of the residual claim—namely, to increase shareholder wealth.")

²⁹ *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 34 (Del. Ch. 2010) ("Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form" and they may not disappoint "other stockholders interested in realizing a return on their investment.").

Based on this shareholder-oriented understanding of corporate purpose and residual claimancy, the residual claimant theory has primarily become a rationale for the shareholder primacy norm—a norm which views corporations as existing to maximize shareholder wealth.³⁰ In this way, the single-criterion profit-residual approach has had a profound effect on how wealth and power are distributed in our society.

B. Challenging Residual Claimancy as a Rationale for Shareholder Primacy

While the premise that shareholders are the residual claimants of corporations has been widely accepted in corporate law scholarship and under Delaware law, it is not a universally held view.³¹ Most prominent among the critics is Lynn Stout, who argues that the view that shareholders are the firm's sole residual claimants rests on empirical claims that are “demonstrably false.”³² In Stout's critique of the shareholder primacy norm, she rejects the characterization that the shareholders are *entitled* to the residual, pointing to the fact that this “entitlement” is contingent upon directors' ability and willingness to declare a dividend.³³

Some scholars have characterized the discretion given to directors as an agency cost that is necessary in order to maximize the residual claimant's interests. Eugene Fama and Michael Jensen, in their 1983 paper, *Separation of Ownership and Control*, explain that although the separation of decision-making from residual claims increases the likelihood of deviant actions, the costs of these deviant actions should be weighed against the

³⁰ See D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 277–78 (1998) (“The structure of corporate law ensures that corporations generally operate in the interests of shareholders.”).

³¹ See, e.g., Lynn A. Stout, *Bad and Not-So-Bad Arguments For Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1189 (2002); Roberta S. Karmel, *Implications of the Stakeholder Model*, 61 GEO. WASH. L. REV. 1156, 1156 (1993) (“The corporate law paradigm that shareholders are the owners of a corporation who elect directors to manage the corporation on the shareholders' behalf is an old-fashioned legal fiction.”); Daniel J. H. Greenwood, *The Dividend Puzzle: Are Shares Entitled to the Residual*, 32 J. CORP. L. 103, 152 (2006).

Shareholders, then, are not entitled to the residual. They do not have the legal right to take it. They do not create it. They do not have market power to demand it. They just have had the good fortune to receive part of it as a side-effect of managerial self-enrichment.

Id.; Simon Deakin, *The Corporation as Commons: Rethinking Property Rights, Governance and Sustainability in the Business Enterprise*, 37 QUEEN'S L.J. 339, 339 (2012) (referring to the shareholder primacy model as “conceptually elegant,” but “fails to describe certain core features of the legal structure of the business corporation”).

³² Stout, *supra* note 31, at 1208.

³³ *Id.* at 1193.

benefits that come with specialization of management.³⁴ According to Fama and Jensen, although directors may not themselves be residual claimants, they can be directed to serve the best interests of residual claimants through contracts.³⁵ They hypothesize that the structure of these contracts will determine the survival of organizations; according to their hypothesis, so long as the cost savings from delegating decision-making to specialized management are greater than the agency costs of delegation, the delegation will add to the survival value of organizations.³⁶

This contractarian explanation is echoed by Easterbrook and Fischel, who characterize a shareholder's relationship with directors as a contract.³⁷ While the contractarian view offers an elegant explanation for why residual claimants own but do not control the corporation, it cannot be used to defend shareholder primacy. This is because the contractual relationship which underlies the residual claim is not fixed (and in many cases are only implied) and may change over time. Instead, any contractual relationship should be understood as one among many residual claimant criteria, which sometimes, but do not exclusively, point to shareholders as residual claimants.

II. CORPORATE RESIDUAL CLAIMANTS: A MULTICRITERIA ASSESSMENT

In this Part, I outline a multicriteria assessment of residual claimancy that draws from the residual claimant's multiple identities that have appeared in legal and economic literature. In Section A, I discuss the origins and applications of each of the residual claimant criteria, and the purposes they serve. In Section B, I apply the multicriteria assessment to evaluate a common shareholder's residual claim.

³⁴ See Fama & Jensen, *supra* note 8. According to Fama and Jensen, the benefits of specialized management become greater with the growing complexity of the organization. See *id.* at 305, 308. The residual claimants of complex organizations are not only numerous (creating collective action costs), but may also be unqualified to make management decisions. See *id.* at 308–09. The “common apex” of these organizations is that a board of directors (who are not residual claimants) ratifies and monitors important decisions on the residual claimants' behalf. See *id.* at 323.

³⁵ See *id.* at 302.

³⁶ See *id.* at 303 (“Producing outputs at lower cost is in the interests of residual claimants because it increases net cash flows, but lower costs also contribute to survival by allowing products to be delivered at lower prices.”).

³⁷ See ECONOMIC STRUCTURE, *supra* note 25, at 36 (“For most firms the expectation is that the residual risk bearers [the shareholders] have contracted for a promise to maximize long-run profits of the firm, which in turn maximizes the value of their stock.”).

A. A Multicriteria Assessment of Corporate Residual Claimants: The Criteria

1. Order of Payment

In his 1893 treatise, *First Lessons in Political Economy*, Francis Walker viewed laborers as the residual claimants because they received the benefit of the amounts that were left over *after* all the other claimants were satisfied.³⁸ Under this analysis, the stakeholder that is paid last is the residual claimant of the corporation. The simple logic underlying this analysis is that the person who is paid the last dollar has the greatest incentive to maximize the number of total dollars that the firm makes.

In modern capital structures with a residual dividend policy,³⁹ the common shareholder is generally the claimant that holds the most junior claim on the firm.⁴⁰ One exception arises when a firm is insolvent and its liabilities exceed its assets. In these cases, shareholders will receive nothing unless the senior claimants (i.e., creditors) consent, and thus the creditors will be deemed the residual claimants of these firms.⁴¹

This first residual claimant criterion is the criterion that has foundationally shaped the modern conception of residual claimants, focusing on the fact that the shareholder is generally the only party who owns the rights to the residual profits, with a narrow exception for insolvent firms. While the distribution and maximization of residual profits is an important consideration, it is not the only goal of residual claimant analysis, as

³⁸ FRANCIS WALKER, *FIRST LESSONS IN POLITICAL ECONOMY* 282 (1893) (explaining that under wage funds theory, “wages receive the benefit of all that is left over after all the other claimants are satisfied”).

³⁹ See Adam Hayes, *Residual Dividend*, INVESTOPEDIA (June 29, 2021), <http://www.investopedia.com/terms/r/residual-dividend.asp> (defining the policy as one that requires that dividends be paid only after all of the project capital requirements have been met) [<http://perma.cc/B23A-EBFF>].

⁴⁰ See Michael T. Gapen, Dale F. Gray, Cheng Hoon Lim & Yingbin Xiao, *The Contingent Claims Approach to Corporate Vulnerability Analysis: Estimating Default Risk and Economywide Risk Transfer*, in *CORPORATE RESTRUCTURING: LESSONS FROM EXPERIENCE*, 261, 263 (Michael Pomerleano & William Shaw eds., 2005) (“The value of the junior claim (equity in the case of firms) is derived from the residual value after the promised debt payments have been made.”).

⁴¹ See, e.g., Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 738 (1988) (“When a firm owes more than its assets are worth, the shareholders receive nothing unless the creditors consent.”); G. Eric Brunstad, Jr. & Mike Sigal, *Competitive Choice Theory and the Unresolved Doctrines of Classification and Unfair Discrimination in Business Reorganizations Under the Bankruptcy Code*, 55 BUS. LAW. 1, 7–8 (1999) (referring to how, in insolvency, “the firm’s unsecured creditors usually become the firm’s ‘residual claimants’” because “the insolvent debtor’s unsecured creditors, rather than its equity holders, are entitled to the benefit of whatever value is left over after the payment of senior claims”).

demonstrated by the other residual claimant criteria discussed in the balance of this Subsection.

2. Variability of Reward

The second residual claimant criterion is concerned with the extent to which a claimant's reward varies depending on the success or failure of the corporation.⁴² It is related to the first criterion (order of payment) in that the first criterion, too, concerns rewards, but the two criteria do not necessarily move in the same direction. As an example, a claimant may be paid first in line but paid a variable amount, triggering this second criterion but not the first. A single-criterion approach that looks only to the order of payment would consider this claimant to have no entitlement to a residual claim, but a broader understanding of residual claimancy which incorporates the second criterion would recognize that this party, too, owns a residual claim.

One prominent articulation of this criterion appears in Fama and Jensen's definition of the "residual risk," which they define as "the risk of the difference between stochastic inflows of resources and promised payments"⁴³ Stochastic inflows refer to the amounts that may not be precisely predicted. Under this criterion, the parties who receive a variable reward are the residual claimants of the corporation. The logic underlying this analysis is that the uncertainty of a variable reward can motivate the claimant to act in the best interests of the corporation.⁴⁴ When one's reward is fixed, these claimants "do no better whether the firm performs 'spectacularly well' or just 'well.'"⁴⁵ As an example, bondholders are not considered to be residual claimants under this criterion, as they are compensated on a fixed basis.⁴⁶

In the large, publicly-traded, investor-owned corporation, the common stockholder benefits when the firm performs spectacularly well.⁴⁷ However, there are a number of other stakeholders who enjoy gains and suffer losses depending on whether a firm performs well or poorly.⁴⁸ Jill Fisch raises the possibility that managers could

⁴² See, e.g., Fama & Jensen, *supra* note 8, at 302.

⁴³ *Id.*

⁴⁴ See *id.*

⁴⁵ Anant K. Sundaram & Andrew C. Inkpen, *The Corporate Objective Revisited*, 15 *ORG. SCI.* 350, 354 (2004).

⁴⁶ See, e.g., Benjamin Klein, *Contracting Costs and Residual Claims: The Separation of Ownership and Control*, 26 *J.L. & ECON.* 367, 369 (1983) (explaining that bondholders are not residual claimants because their compensation is not contractually set on a profit-sharing basis).

⁴⁷ Fama & Jensen, *supra* note 8, at 303.

⁴⁸ See Bernard Black, *Corporate Law and Residual Claimants* (Stanford L. Sch. John M. Olin Program in L. & Econ., Working Paper No. 217, 2001) (noting that the

too be considered to be residual claimants, in light of the shift toward greater performance-based managerial compensation.⁴⁹ Going even further, the government, as tax collector, can also be viewed as a residual claimant under this criterion.⁵⁰

One way to narrow the wide spectrum of potential residual claimants derived from this criterion is by evaluating claimants not just on the direction but on the *degree* to which their reward is sensitive to the firm's performance. Thomas Smith engages in this analysis to conclude that the parties who are *most* sensitive to a firm's performance are call option holders.⁵¹ In contrast, Frank Partnoy has used the put option and call option perspectives to demonstrate that debtholders are the true residual owners of firms.⁵² Both authors caution, however, against a principle that would treat these holders as the beneficiaries of the fiduciary claim.⁵³ For example, Smith warns that option holders will favor high-risk projects that would increase the value of their options even if they would decrease the value of the firm.⁵⁴ These concerns can be restated, using the framework of this Article, as an acknowledgement that while call option holders satisfy one (i.e., variable reward) of the residual claimant criteria, they fail to embody others (e.g., risk of loss). It highlights the potentially harmful consequences of using a single-criterion approach to determining residual claims.

conventional contractarian explanation that only common shareholders have voting rights because they are the firm's principal residual claimants "doesn't fit the facts," and that "[o]ther claimants, including employees, creditors, preferred shareholders, option holders, suppliers, customers, and the government (as tax collector), also generally gain when a firm does well and suffer when the firm does badly").

⁴⁹ Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 636, 658 n.122 ("Indeed, one might argue that the shift toward greater performance-based compensation for management has converted managers into residual claimants, resulting in a form of managerial capitalism."). *But see* Henry L. Tosi, Steve Werner, Jeffrey P. Katz & Luis R. Gomez-Mejia, *How Much Does Performance Matter? A Meta-Analysis of CEO Pay Studies*, 26 J. MGMT. 301, 329–30 (2000) (suggesting that firm size, more so than firm performance, accounts for variance in CEO pay by showing that "firm size accounts for more than 40% of the variance in CEO pay," while firm performance accounts for less than five percent of the variance).

⁵⁰ *See, e.g.*, Black, *supra* note 48, at 7 (describing the government's "strong residual interest"); *see also* Omri Marian, *Is All Corporate Tax Planning Good for Shareholders?*, 52 U.C. DAVIS L. REV. 905, 927–42 (2018) (examining the complicated relationship between corporate tax planning and shareholder value).

⁵¹ Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 260–61 (1999).

⁵² Frank Partnoy, *Financial Innovation in Corporate Law*, 31 IOWA J. CORP. L. 799, 808 (2006) ("The put option and call option perspectives demonstrate that the legal rule could be the opposite: corporate law could assign control to debt and force equity to bargain for contractual protection.").

⁵³ *See id.* at 802; *see also* Smith, *supra* note 51, at 260–61.

⁵⁴ *See id.* at 261.

3. Wealth Effect of Own Decisions

The third residual claimant criterion looks to whether or not a claimant bears the major share of the wealth effects of their decisions. This criterion focuses on how a residual claimant's own efforts relate to the residual claimant's reward. To be considered a residual claimant under this criterion, there must be a strong correlation between the claimant's effort and reward.⁵⁵

An early articulation of this criterion appears in Jacob Hollander's 1903 paper, where he explains that the entrepreneur's status as residual claimant depends on the profit of the enterprise being large or small according to the efforts of the entrepreneur.⁵⁶ The same idea appears in the work of Fama and Jensen, who explain that those who do not bear a major share of the wealth effects of their decisions are not major residual claimants of firms.⁵⁷

The correlation between effort and reward is relevant to the design of incentives.⁵⁸ Oliver Hart and John Moore explain that those who have the ability to enhance to value of an asset will often be motivated to become owners of that asset.⁵⁹ Employee profit-sharing is based on the premise that giving employees some ownership of the enterprise will enhance labor productivity.⁶⁰

The broad authority that directors enjoy within the firm, coupled with the increasing use of performance-based executive compensation, suggests that directors, rather than shareholders, fit better with this residual claimant criterion. This logic has been used to explain why rank-and-file employees should also be

⁵⁵ See, e.g., Jacob H. Hollander, *The Residual Claimant Theory of Distribution*, 17 Q.J. ECON. 261, 277 (1903) ("Pure profit may be 'the prize of the social contest'; but the award is not by blind chance nor by uncontrollable circumstance, but a definite return for positive service.").

⁵⁶ *Id.* at 277 ("[Pure profit] will be great or small according to the success or failure of the entrepreneur in anticipating dynamic changes and in adjusting his operations accordingly.").

⁵⁷ Fama & Jensen, *supra* note 8, at 304.

⁵⁸ See, e.g., Alchian & Demsetz, *supra* note 7, at 779 (arguing that input productivity is greater when productivity and rewards are highly and accurately related).

⁵⁹ Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119, 1149 (1990) ("[A]n agent is more likely to own an asset if his action is sensitive to whether he has access to the asset and is important in the generation of the surplus . . .").

⁶⁰ See, e.g., Vikram Kumar, *Profit Shares as Virtual Equity: Short-Run Isomorphism of Share & Wage Systems*, 11 INT'L J. ECON. FIN. 45, 46 (2019) ("Profit-sharing is often administered in industry on the premise that imbuing labor with a sense of ownership of the enterprise and attaching their personal fortunes to that of the firm will enhance labor productivity."); see also Joseph Blasi, Douglas Kruse & Richard B. Freeman, *Broad-based Employee Stock Ownership and Profit Sharing: History, Evidence, and Policy Implications*, 1 J. PARTICIPATION & EMP. OWNERSHIP 38, 38 (2018).

considered residual claimants, as their gains and losses depend primarily on their own efforts.⁶¹

4. Firm-specific Investments

The fourth residual claimant criterion is concerned with a claimant's unprotected firm-specific investments. Firm-specific investments refer to investments that are of greatest value when specifically used by and within that particular firm. Pointing to the fact that many non-shareholder stakeholders make firm-specific investments, Margaret Blair and Lynn Stout have argued that shareholders cannot therefore be the only residual claimants to the firm's earnings.⁶²

In particular, Blair has been a forceful proponent of workers and their residual interests, relying on the firm-specific aspects of human capital.⁶³ Bernard Black, too, has suggested that we might consider employees to be residual claimants of firms since employees develop firm-specific knowledge, and the value of this knowledge is directly tied to the firm's success.⁶⁴ According to Black, these and other considerations produce an "employee residual interest that is of the same order of magnitude as the common shareholders' interest."⁶⁵

5. Protection Against Non-payment

The fifth residual claimant criterion defines the residual claimant as the claimant who has the least recourse in the event of non-payment. One articulation of this criterion appears in John Clark and Franklin Giddings' 1888 treatise, which depicts the residual claimant as one who waits for "rain from the clouds" that has "nothing to do but receive it . . . without appeal."⁶⁶ It should be noted that this criterion can sometimes be in tension with the third criterion (wealth effect of one's own decisions), which requires that a residual claimant's decision has a major effect on whether or not the rain falls.

⁶¹ See, e.g., Min Yan, *Agency Theory Re-examined: An Agency Relationship and Residual Claimant Perspective*, 26 INT'L CO. & COM. L. REV. 139, 143–44 (2015); see also Bruce A. Rayton, *The Residual Claim of Rank and File Employees*, 9 J. CORP. FIN. 129, 144 (2001) ("The gains of winning firms accrue not only to shareholders and CEOs, but also to average employees.").

⁶² Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, 31 J. CORP. L. 719, 728 (2006) (arguing that because non-shareholder stakeholders make firm-specific investments that are not always protected through explicit contracting, shareholders are not the only residual claimants to the firm's earnings).

⁶³ MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 27 (1995).

⁶⁴ Black, *supra* note 48, at 26.

⁶⁵ *Id.* at 27.

⁶⁶ JOHN B. CLARK & FRANKLIN H. GIDDINGS, *THE MODERN DISTRIBUTIVE PROCESS: STUDIES OF COMPETITION AND ITS LIMITS* 40 (Boston, Ginn & Co. 1888).

Focusing on dividends, common shareholders are well-aligned with this criterion since their dividends depend on the performance of the company and, even in the cases where the company does well, dividends may be withheld at the discretion of the board of directors. On the other hand, a bondholder's interest payments may not generally be withheld without placing the corporation in default.

Using an externality framework that draws from the same logic as this residual claimant criterion, Yair Listokin and Inho Mun suggest that all members of the broader economy could be considered to be the residual claimants during financial crises.⁶⁷ They suggest that fiduciary duties should thus be modified to consider the interests of these members in systemically important and failing firms during crises.⁶⁸

6. Undiversified Risks

The sixth residual claimant criterion considers the extent to which a claimant is protected from risk of loss through diversification of their investment portfolio. This criterion appears in Fama and Jensen's characterization of the residual claimant as a party who has foregone risk reduction through portfolio diversification.⁶⁹

Shareholders who invest through an index fund would not be a residual claimant under this criterion. On the other hand, an investor who owns shares of only one company would clearly satisfy this residual claimant criterion.

Noting that diversification is not available as a loss protection mechanism to many stakeholders, Richard Booth has argued that these stakeholders (including employees, creditors, customers, suppliers, and the community at large) deserve additional statutory protections.⁷⁰ Notably, it is difficult for employees to hold a diversified employment portfolio. An employee will not be able to gain simultaneous employment in multiple companies with the same ease with which an investor can invest in multiple companies to achieve portfolio diversification.⁷¹ This characteristic of employees makes them a strong candidate for residual claimant status under this criterion.

⁶⁷ Yair J. Listokin & Inho Andrew Mun, *Rethinking Corporate Law During a Financial Crisis*, 8 HARV. BUS. L. REV. 349, 353–54 (2018).

⁶⁸ *See id.* at 354.

⁶⁹ Fama & Jensen, *supra* note 8, at 306 (“[R]esidual claimants forgo optimal risk reduction through portfolio diversification so that residual claims and decision making can be combined in a small number of agents.”).

⁷⁰ Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429, 432, 437 (1998) (“By diversifying, stockholders have already hedged their bets and would be overcompensated by any additional award of damages.”).

⁷¹ It should be noted, however, that the ability for employees to diversify their employment portfolios is changing with the gig economy. *See, e.g.*, Diane Mulcahy, *Who*

7. Bargaining Power

Another residual claimant criterion looks at a claimant's bargaining position compared to other claimants. For example, Jacob Hollander explained that, in industrial England, the conspicuous fact which became the breeding ground for the capital residual theory was that "the other productive factors worked *for* the capitalist, not *with* him."⁷² In the modern context, Kent Greenfield notes how large shareholders of firms have used their superior bargaining power to gain the protection of legal rules which force management to shift as much of the surplus to them as possible.⁷³

As a practical matter, we would first need to develop a measurable and comparable definition of one's bargaining strength. Russell Coff provides such a definitional framework by identifying four factors which can be used to assess the relative bargaining strength of corporate stakeholders.⁷⁴ The first is the capacity to act in a unified manner, the second is access to key information, the third is high replacement cost to the firm, and the fourth is low exit costs.⁷⁵

Shareholders of a large, open firm generally do not do well under this conception of bargaining power, as they meet only one (low exit costs) of the four criteria. They tend to be dispersed, which makes it difficult to act in a unified manner, they are often unqualified and uninformed, and the open capital markets provide firms with a stable, rotating, and replaceable source of capital.

This discussion demonstrates the challenges of using one brush to paint an entire stakeholder group. Using the example of GameStop, a "GameStop shareholder" includes both a day trader who holds a single share or a fraction thereof, as well as a hedge fund, like Senvest, which at one time owned more than five percent of the company.⁷⁶ There is a significant differential in bargaining power between these two groups of shareholders.

Recognizing the relatively strong bargaining power of employees, some have argued that employees should have equal

Wins in the Gig Economy, and Who Loses, HARV. BUS. REV. (Oct. 27, 2016), <http://hbr.org/2016/10/who-wins-in-the-gig-economy-and-who-loses> [<http://perma.cc/6BSH-EL6Y>].

⁷² Hollander, *supra* note 55, at 267 ("The conspicuous fact in the industrial England of the Ricardians was that the other productive factors worked *for* the capitalist, not *with* him.").

⁷³ Kent Greenfield, *Defending Stakeholder Governance*, 58 CASE W. RES. L. REV. 1043, 1044 (2008).

⁷⁴ Russell W. Coff, *When Competitive Advantage Doesn't Lead to Performance: The Resource-based View and Stakeholder Bargaining Power*, 10 ORG. SCI. 119, 122 (1999).

⁷⁵ *See id.*

⁷⁶ *See, e.g.*, Douglas MacMillan & Yeganeh Torbati, *How the Rich Got Richer: Reddit Trading Frenzy Benefited Wall Street Elite*, WASH. POST (Feb. 8, 2021, 11:53 AM), <http://www.washingtonpost.com/business/2021/02/08/gamestop-wallstreet-wealth/> [<http://perma.cc/M2B4-T6BN>].

status to shareholders in firms.⁷⁷ Under the seventh residual claimant criterion, employees, just as much as shareholders, should be considered to be the residual claimants of firms.

8. Express and Implied Contracts

The eighth residual claimant criterion seeks to identify the party whose relationship with the corporation is most difficult to specify by contract.⁷⁸ While it is commonly understood that shareholder interests are hard to express via contract, this criterion is not exclusively embodied by shareholders.

Notably, the difficulty of precisely specifying employee effort via contract is well understood. For example, Benjamin Klein describes the difficulty of measuring the level and form of energy that managers must devote to a complex task.⁷⁹ Alexander Gavis notes the especial challenge that employees face in negotiating for contingencies in the context of a takeover.⁸⁰ Some have attributed these challenges to the lifecycle model of employment, which involves an implicit but unwritten arrangement that employees will receive less earlier on in exchange for additional compensation later.⁸¹ Others have pointed to the prevalence of unwritten or sparsely written employment arrangements as one of the reasons why employees may be considered to be residual claimants of firms.⁸² Fisch has also noted the ways in which employees'

⁷⁷ See J. Kaler, *An Optimally Viable Version of Stakeholder Theory*, 86 J. BUS. ETHICS 297, 304 (2009).

⁷⁸ See, e.g., Emily Winston, *Managerial Fixation and the Limitations of Shareholder Oversight*, 71 HASTINGS L.J. 699, 736 (2019) (“[U]nspecified contract terms are areas where residual control is exercised.”); see generally Frank Easterbrook & Daniel Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

⁷⁹ Klein, *supra* note 46, at 367–68 (describing the impossibility of writing a complete contract to prevent managerial shirking because “the number of contingencies is so large and the tasks to be performed by a manager hired by an owner of a firm so complex”).

⁸⁰ Alexander C. Gavis, *A Framework for Satisfying Corporate Directors’ Responsibilities Under State Nonshareholder Constituency Statutes: The Use of Explicit Contracts*, 138 U. PA. L. REV. 1451, 1472 (1990) (“[E]mployment contracts usually do not include consideration for employees’ expectations that exist as a result of their investment of human capital in corporations.”).

⁸¹ Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27, 40 (1996).

Besides shareholders, employees are probably the class of patrons that is least able to contract with the corporation. According to the life-cycle model of employment compensation, employees and firms enter into efficiency-enhancing implicit employment contracts in which employees agree to receive less in wages than their then-current marginal product in exchange for extra compensation later in their career.

Id.

⁸² Black, *supra* note 48, at 25–27 (explaining that wages are often back-loaded (e.g., severance, retirement benefits, seniority-based pay), and these back-loaded benefits are lost by employees if a firm fails); see also Edward B. Rock & Michael L. Wachter, *The Enforceability of Norms and the Employment Relationship*, 144 U. PA. L. REV. 1913, 1917 (1996).

contracts are incomplete, illiquid, and imperfectly priced, and how employees lack hedging mechanisms, such as insurance, to protect against risk.⁸³ For these reasons, it could be said that employees, more so than shareholders, should be considered to be the residual claimants of firms under this criterion.

9. Monitoring Capacity

The ninth residual claimant criterion considers the claimant's monitoring ability. This criterion appears in Alchian and Demsetz's characterization of the residual claim as a mechanism to incentivize a monitor to effectively perform his monitoring function.⁸⁴ Their definition of the monitoring function involves not only price-setting but also observing and directing the actions or uses of these inputs. It is clear from their analysis that managers are the residual claimants of firms.⁸⁵

Shareholders are typically considered to be unsuitable monitors,⁸⁶ although a distinction should be drawn between retail investors and institutional shareholders, with the latter group possessing superior monitoring powers.⁸⁷ In addition, the capital markets and the market for corporate control are sometimes considered to be effective substitutes for shareholder monitoring.⁸⁸ Generally speaking, creditors, trustees, and suppliers are considered to be better monitors of firms than shareholders, and would be the residual claimants of firms under this criterion.⁸⁹

B. A Multicriteria Assessment of the Shareholder's Residual Claim

According to the multicriteria assessment outlined in Section A above, a corporate residual claimant embodies the nine criteria and identities listed in Table 1 below.

⁸³ Fisch, *supra* note 49, at 659.

⁸⁴ Alchian & Demsetz, *supra* note 7, at 782–83 (designating the monitor as the residual claimant will incentivize him to earn “his residual through the reduction in shirking that he brings about, not only by the prices that he agrees to pay the owners of the inputs, but also by observing and directing the actions or uses of these inputs”).

⁸⁵ *See id.* at 783.

⁸⁶ *See, e.g.*, Van Der Weide, *supra* note 81, at 35 (“Shareholders are widely dispersed and thus unable to monitor a firm's management effectively—unlike a supplier, a bank, an indenture trustee, or a union.”).

⁸⁷ *See, e.g.*, John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991).

⁸⁸ For a discussion of monitoring from the capital markets, see Fama & Jensen, *supra* note 8, at 313 (“Stock prices are visible signals that summarize the implications of internal decisions for current and future net cash flows. This external monitoring exerts pressure to orient a corporation's decision process toward the interests of residual claimants.”). For monitoring from the takeover markets, see Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

⁸⁹ *See, e.g.*, Van Der Weide, *supra* note 81, at 35.

Table 1. The Nine Residual Claimant (R-C) Criteria

Criteria	R-C Identity
1. Order of Payment	Junior (last)
2. Variability of Reward	Variable
3. Wealth Effect of Own Decisions	High
4. Firm-Specific Investments	High
5. Protection against Non-Payment	None
6. Undiversified Risk	Unlimited
7. Bargaining Position	Strong
8. Contract Specification	Difficult
9. Monitoring Capacity	High

Analyzing the common shareholder of a large, open corporation under the nine criteria, I find that the common shareholder clearly and predominantly embodies only two (marked “Yes” under the second column in Table 2 below) of the residual claimant criteria. Common shareholders satisfy the first criterion (order of payment) because they are generally the claimant that holds the most junior claim on the firm. They also satisfy the fifth criterion (protection against non-payment) because a shareholder who loses money from their investment has no recourse against the company or its directors, barring a breach of fiduciary or other legal duty.

Shareholders to some extent, but other stakeholders to a greater extent, embody four (marked “Mixed” under the second column in Table 2 below) of the residual claimant criteria. For example, although there are some shareholders who embody the sixth criterion (undiversified risk) by holding an undiversified investment portfolio, it is generally and comparatively more difficult for employees to diversify their employment risks, which makes them a more likely residual claimant according to this criterion. The other “Mixed” criteria are the second criterion (variability of reward), the seventh criterion (bargaining position), and eighth criterion (contract specification).

Furthermore, the common shareholder fails to embody three (marked “No” under the second column in Table 2 below) of the residual claimant criteria. These are the third criterion (wealth effect of one’s own decisions), fourth criterion (firm-specific investments), and ninth criterion (monitoring capacity).

Table 2. Assessing the Common Shareholder under the Nine Residual Claimant (R-C) Criteria

Criteria	Embodied by Shareholders?
1. Order of Payment	Yes
2. Variability of Reward	Mixed
3. Wealth Effect of Own Decisions	No
4. Firm-Specific Investments	No
5. Protection against Non-Payment	Yes
6. Undiversified Risk	Mixed
7. Bargaining Position	Mixed
8. Contract Specification	Mixed
9. Monitoring Capacity	No

While the residual claimant theory has been used as a rationale for shareholder primacy based on a single-criterion profit-residual approach, the shareholder's status as residual claimant is unstable when evaluated through a multicriteria assessment. This instability has numerous facets and implications, which are explored in greater detail in the next Part.

III. ACKNOWLEDGING THE DYNAMIC NATURE OF CORPORATE RESIDUAL CLAIMS

The availability of multiple criteria in assessing residual claimancy reveals that residual claimant status is dynamic—it may be shared among multiple groups, only some but not all members of a group may be residual claimants, a member or group may have the characteristics of both a residual claimant and a non-residual claimant, the residual claimant may change over time, there may be no residual claimant, and it may be difficult or impossible to know who the residual claimant is. Each of these facets and proposed solutions are described in Section A. Section B further examines two analytical frameworks that may be more compatible with a dynamic understanding of corporate residual claimants.

A. The Dynamic Nature of Corporate Residual Claims

1. Multiple Residual Claimants

A multicriteria assessment will necessarily produce multiple stakeholders who satisfy the various residual claimant criteria. The observation that there may be more than one group of residual claimants in a firm is not new. Lynn LoPucki dispels the myth of the single residual owner in the context of reorganizing firms in his paper, *The Myth of the Residual Owner: An Empirical Study*.⁹⁰ LoPucki designs an empirical study to test whether it is possible to identify a single residual owner in reorganizing firms, and concludes that “no identifiable, single residual owner class exists in most reorganizing large public companies.”⁹¹ He finds that there are multiple investor priority levels in the companies’ financial structures, which suggests that investors at more than one level will share residual owner status.⁹² LoPucki confirms this by showing that in sixty-two percent of the firms he studied (forty-eight of seventy-eight cases), no identifiable single residual owner existed.⁹³ According to LoPucki: “The problem is not merely that single residual owners are difficult to identify. The problem is that they rarely exist.”⁹⁴ While LoPucki’s study was focused on reorganizing firms, this task of identifying a single group of residual owners extends to companies as a going concern.

Acknowledging this gap between the myth of a single residual claimant and a much more complicated reality, three notable alternatives have been proposed. First, Margaret Blair and Lynn Stout have suggested that in situations where multiple stakeholders’ interests are implicated, directors, whom they call the “mediating hierarchs,” should have control and balance the interests of all stakeholders.⁹⁵ Second, Simon Deakin has argued that the commons model offers a better legal structure of the firm, in which various stakeholders have overlapping claims in

⁹⁰ Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH. U.L.Q. 1341 (2004).

⁹¹ *Id.* at 1343.

⁹² *Id.*

⁹³ *Id.* at 1361.

⁹⁴ *Id.* at 1343.

⁹⁵ Blair & Stout, *supra* note 62, at 738.

When corporate production requires more than one individual or group to make specific investments, problems of intrafirm opportunism arise as shareholders try to exploit each other and try as well to exploit creditors, employees, customers, and other groups that make specific investments. Board authority, while worsening agency costs, may provide a second-best solution to such intrafirm rent-seeking.

Id. at 720.

relation to its assets.⁹⁶ Third, Raghuram Rajan and Luigi Zingales have proposed a structure that transfers ownership to an unaffiliated outsider when there are multiple stakeholders who have made substantial firm-specific investments over time.⁹⁷

2. The Heterogeneity Problem

Even when there is a single residual claimant group within the corporation, only some (but not all) members of that group may be residual claimants. Henry Hansmann views this heterogeneity within a claimant group as a critical determinant of the cost of ownership, and one that favors shareholders.⁹⁸ Similarly, Grant Hayden and Matthew Bodie have suggested that it is the supposed homogeneity of shareholder interests that makes the discussion of the shareholder residual meaningful as a normative theory.⁹⁹ However, Hayden and Bodie reach a different conclusion from Hansmann by noting that the claim of shareholder homogeneity has recently come under pressure, thereby eroding the normative value of residual claimant theory as a rationale for shareholder primacy.¹⁰⁰

One phenomenon that illustrates heterogeneity among shareholders is empty voting, which refers to the decoupling of voting rights from economic interests.¹⁰¹ An empty voter is able to retain their voting rights even though they have hedged away their economic interests by, for example, buying a put option to sell the shares they hold.¹⁰² In light of these derivative investments, these empty voters may stand to benefit from the firm doing worse. In that sense, they are antithetical to the values we attach to or expect from a residual claimant. In spite of

⁹⁶ Deakin, *supra* note 31.

⁹⁷ Raghuram G. Rajan & Luigi Zingales, *Power in Theory of the Firm*, 113 Q.J. ECON. 387, 422 (1998) (“[I]f all the parties involved in production (i.e., including the entrepreneur) have to make substantial specific investments over time, it may be optimal for a completely unrelated third party to own the assets.”).

⁹⁸ See HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 62 (1996) (“Investor-owned firms have the important advantage that their owners generally share a single well-defined objective: to maximize the net present value of the firm’s earnings.”).

⁹⁹ Grant M. Hayden & Matthew T. Bodie, *Shareholder Voting and the Symbolic Politics of Corporation as Contract*, 53 WAKE FOREST L. REV. 511, 522 (2018) (“The argument from the residual, then, largely rests on this claim of shareholder homogeneity. It is what makes this discussion of the shareholder residual into a meaningful normative theory, rather than a simple restatement of positive corporate law.”).

¹⁰⁰ See *id.* at 522–24 (describing the heterogeneity of shareholder interests).

¹⁰¹ See Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 811–12 (2006).

¹⁰² For example, in the proposed acquisition of King Pharmaceuticals by Mylan, Perry Corporation sought to protect its economic stake in King by taking an “empty voting” position in Mylan through hedging transactions that insulated Perry from the economic risks of owning Mylan stock. Perry Corp., Exchange Act Release No. 2907, 2009 WL 2163550 (July 21, 2009).

these conflicts, empty voters have been able to use their legal status as “residual claimants” to advance their private interests at the expense of other true residual claimants of the firm.¹⁰³

LoPucki coined the term “pseudo-residual owners” to refer to holders of residual interests that differ from those of the firm.¹⁰⁴ Small deviations of the pseudo-residual owner’s interests from the firm’s interests can create significant conflicts among parties.¹⁰⁵ In the bankruptcy context, the system might be liquidating firms that should instead reorganize.¹⁰⁶ In solvent firms, even small misalignments can have an outsized impact on investment policy.¹⁰⁷

Some proposed solutions to address these misalignments include vote-buying restrictions, disclosure requirements,¹⁰⁸ governance fixes (e.g., improved record keeping), and *ex post* enforcement.¹⁰⁹ These efforts seek to align the legal and true residual claimants of firms by requiring the members of the legally designated residual claimant group to retain the attributes that made them residual claimants in the first place.

3. Mixed Residual Claimants

In addition to conflicting loyalties among individuals within a stakeholder group, there can also be conflicting loyalties within one individual. Like a permanent resident who might be a citizen of one country and a resident of another, some residual claimants have multiple allegiances, which at times might conflict with one another. Roberta Karmel has argued that stakeholder statutes were initially a reaction to the growing significance of pension funds that have such mixed interests; they hold equity, but also hold debt and represent employee interests.¹¹⁰ Hybrid instruments can further complicate this analysis.¹¹¹

¹⁰³ See, e.g., Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1395, 1398 (2007).

¹⁰⁴ LoPucki, *supra* note 90, at 1368 (“Pseudo-residual owners have interests that differ from those of the firm.”).

¹⁰⁵ *Id.* (citing Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 788–96 (1993)).

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ The challenge of disclosure is that disclosure obligations hinge on materiality, which may have the unintended consequence of encouraging the undesired behavior up to the threshold that triggers the disclosure obligation. George S. Georgiev, *Too Big to Disclose: Firm Size and Materiality Blindspots in Securities Regulation*, 64 UCLA L. REV. 602, 602 (2017).

¹⁰⁹ See Hu & Black, *supra* note 101, at 819–20.

¹¹⁰ Karmel, *supra* note 31, at 1157 (“[P]ension funds, which are the largest and most influential of the institutional investors, hold debt as well as equity, represent employees, and often are political players.”).

¹¹¹ See generally William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667 (1984) (discussing convertible bonds);

One way to navigate the mixed nature of a stakeholder's interests has been to separate a stakeholder according to its different functional roles and then to assign residual claimant status to the specific role that is most pertinent to the residual claimant analysis. As an example of this approach, in his defense of the profit residual theory, Hollander viewed the entrepreneur as the residual claimant of the firm, but only in relation to his role as a merchant who bought out his partners in order to become the owner of a business operation.¹¹²

4. Shifting and Temporary Residual Claimants

Even if there were a single and homogenous residual claimant group that satisfied the applicable residual claimant criteria, the specific members of that group might change over time. A key feature of a publicly traded corporation is that its shares are freely transferable. While the costless handover of residual claimant status is essential to a well-functioning capital market, frequent turnover makes it impossible to maintain a consistent residual claimant base.

One answer to the potential problems caused by shifting and temporary residual claimants is that the efficient capital markets and the market for takeovers will compel whoever is in charge of the corporation's decision process (usually a board of directors) to serve the interests of residual claimants continually and consistently, even though the composition of those claimants will continue to change.¹¹³

5. Unknown Residual Claimants

The analysis thus far has assumed that the characteristics used to assess a claimant's fit with the residual claimant criteria are known and measurable. But these characteristics are not always observable. For example, the third criterion (wealth effect of own decisions) requires one to analyze the wealth effect of each stakeholder's decisions. However, as articulated by Alchian and Demsetz, "marginal products of cooperative team members are not so directly and separably (i.e., cheaply) observable."¹¹⁴

Another concern is that the residual claimant concept may itself be a fiction. As Thomas Jackson and Robert Scott observed

Victor Fleischer, *Taxing Founders' Stock*, 59 UCLA L. REV. 60, 72 (2011) (discussing convertible preferred stock).

¹¹² Hollander, *supra* note 55, at 277 ("[T]he mercantile activity which finds scope only under dynamic conditions—rests upon positive qualifications, and is exercised with more or less success according to the degree in which these qualifications are possessed.")

¹¹³ See Hart & Moore, *supra* note 59, at 1149–50.

¹¹⁴ Alchian & Demsetz, *supra* note 7, at 780.

in the bankruptcy context: “the objective of the collective is never entirely congruent with the objective of any of the constituent parts.”¹¹⁵ Christopher Frost has described the challenge of identifying the residual claimant in firms as “an insurmountable obstacle to the full realization of such a theoretically neat solution.”¹¹⁶ As such, some have proposed lessening the emphasis on the residual claimant concept¹¹⁷ or reconsidering its use in corporate law altogether.¹¹⁸

In my view, the residual claimant theory continues to have tremendous value for corporate law and governance, but it requires that we be transparent about which criterion we are using to designate a particular stakeholder as the residual claimant, and why. Many of the key debates in the residual claimant literature can be characterized as disputes about the appropriate criteria to be used to determine residual claimant status. The multicriteria assessment offers an analytical framework that can be used to mediate these disputes.

B. Using a Multicriteria Assessment to Evaluate Corporate Residual Claims

1. Multicriteria Assessment and the Stakeholder Model

While much of the current focus of corporate law and governance has been on the maximization of shareholder profit, the multicriteria assessment developed in this Article shows that the infra-firm relationships built by rewarding risk-taking and incentivizing firm-specific investments and monitoring have been just as important as profit generation in the history and development of residual claimant analysis.

A multicriteria assessment of residual claimants acknowledges the diverse contributions and capabilities of multiple stakeholders and opens up the possibility of a more pluralistic governance structure. This view of corporate residual claimants is more aligned with a stakeholder model of

¹¹⁵ Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 159 (1989).

¹¹⁶ Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, 72 AM. BANKR. L.J. 103, 115 (1998).

¹¹⁷ See, e.g., Oliver E. Williamson, *Organization Form, Residual Claimants, and Corporate Control*, 26 J.L. & ECON. 351, 356 (1983) (contending that Fama and Jensen's argument that “the condition of residual risk bearing is fully determinative of organization form . . . assigns an unwarranted importance to residual risk bearing”) (emphasis added).

¹¹⁸ See, e.g., Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283, 304 (1998) (“There is nothing inherent in the nature of a residual claim that means that its holders' interest should be maximized above all others.”).

corporations that recognizes that directors have a duty to serve the interests of all corporate constituencies.¹¹⁹

While some view the stakeholder model as giving directors excessive discretion that allows them to act for their own personal interests,¹²⁰ a more balanced understanding of the model is as one that imposes a responsibility upon directors to prevent any one constituency (including the directors themselves) from usurping a corporation's wealth for its own use.¹²¹ The multicriteria assessment outlined in this Article can be used by directors to weigh and mediate the multiple and competing residual claims among various stakeholders.

At the same time, the multicriteria assessment and stakeholder model of residual claimancy present their own set of challenges. A more diverse conception of the residual claimant will necessarily increase the complexity of the analysis. Black has articulated the trade-off as follows: “[While] scattering residual interests widely has efficiency advantages . . . [it is] costly to distribute control rights as widely as residual interests.”¹²² He identifies this difficulty of allocating scarce control rights among multiple residual claimants as one of the important design problems in corporate governance.¹²³

2. Choice Among Criteria

One of the challenges of a multicriteria analysis is that it can produce varying results based on the weight one allocates to the various criteria. Furthermore, any multi-criteria analysis is susceptible to criteria-arbitrage, meaning that the analysis could be tailored, *ex post*, to fit one's preference regarding the allocation of power by reference to any one among the multiple criteria that supports the preferred allocation. Even at its

¹¹⁹ Van Der Weide, *supra* note 81, at 31–32; *see also* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1160 (1932).

¹²⁰ *See, e.g.*, Bebchuk & Tallarita, *supra* note 24; Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001) (“[A] stakeholder measure of managerial accountability could leave managers so much discretion that managers could easily pursue their own agenda, one that might maximize neither shareholder, employee, consumer, nor national wealth, but only their own.”).

¹²¹ *See* Andrew F. Tuch, *Reassessing Self-Dealing: Between No Conflict and Fairness*, 88 FORDHAM L. REV. 939, 940–41 (2019) (“Corporate law is fundamentally concerned with self-dealing—the expropriation of corporate wealth by fiduciaries.”); Karmel, *supra* note 31, at 1175 (“Future interpretations of these statutes should motivate directors to prevent any single constituency from usurping a corporation's capitalization for its own use in such a manner that other valid constituencies are significantly harmed.”).

¹²² Black, *supra* note 48, at 12.

¹²³ *Id.* (“An important corporate governance design problem, hidden by the assumption that the common shareholders are a firm's principal residual claimants, is how to allocate the scarce resource of control rights among multiple classes of residual claimants.”).

inception, the residual claimant theory was viewed skeptically by some as a physiocratic doctrine dressed up as a theory.¹²⁴

One method that could be used to manage this variance is to first identify which criterion among the various residual claimant criteria is most relevant to a particular corporate governance mechanism. Next, the analysis should focus only on the chosen criterion to determine the party to or from whom that particular governance mechanism should run.

One example of this approach can be found in Alchian and Demsetz's analysis of residual claimants.¹²⁵ According to these authors, the primary purpose of the residual claim is a monitoring function.¹²⁶ The only group that met this criterion in their view was the central employer.¹²⁷ As for shareholders, Alchian and Demsetz view them solely as investors (like bondholders), and while these shareholders receive a residual claim on earnings, this residual claim is not relevant to Alchian and Demsetz's analysis as it has no bearing on shareholders' capacity as monitors.¹²⁸ Using the framework of the multicriteria assessment presented in this Article, it can be said that Alchian and Demsetz focus only on the ninth criterion (monitoring capacity) in their residual claimant analysis.¹²⁹

Another example is the approach of Benjamin Klein, who views incentives as the primary purpose of contingent profit-sharing contracts.¹³⁰ Even though shareholders are compensated on a profit-sharing basis, this fact has no bearing on Klein's analysis, as "[t]here is no incentive reason for [a shareholder] not to be compensated on a fixed payment schedule."¹³¹ In other words, only

¹²⁴ Hollander, *supra* note 55, at 261 (referring to Francis A. Walker's residual claimant theory as "the early emergence and curious persistence, in successive guise, of a theory of distribution conveniently denominated in the phrase of one of its most distinguished expositors 'the residual claimant' theory").

¹²⁵ Alchian & Demsetz, *supra* note 7, at 782–87, 794.

¹²⁶ *See id.* at 781–86 (noting that the monitoring function is an important function in performing the residual claim analysis).

¹²⁷ *See id.* at 783–87, 794.

¹²⁸ *Id.* at 789 n.14.

Instead of thinking of shareholders as joint owners, we can think of them as investors, like bondholders, except that the stockholders are more optimistic than bondholders about the enterprise prospects. . . . The residual claim on earnings enjoyed by shareholders does not serve the function of enhancing their efficiency as monitors in the general situation. The stockholders are "merely" the less risk-averse or the more optimistic member of the group that finances the firm.

Id.

¹²⁹ *See id.* at 368–70, 372–73.

¹³⁰ *See* Klein, *supra* note 46, at 368–70.

¹³¹ *Id.* at 368–69 ("A primary purpose of contingent profit-sharing contracts is to create appropriate economic incentives. Obviously, this is not the reason outside (nonmanager) stockholders are compensated on a profit-sharing basis.").

profit-sharing that has an incentive effect is relevant to Klein's analysis of a residual claimant.¹³² Relating Klein's approach to the multicriteria framework, it can be said that Klein focuses on the third criterion (wealth effect of one's own decisions) but disregards the others in his residual claimant analysis.¹³³

Taking voting as another example, why is it that the vote follows the residual claim? Is it because the residual claimant has the most to gain? If so, then we should focus on the three criteria relating to reward calculus (order of payment, variability of reward, and wealth effect of own decisions) to set mandatory voting rules. Or is it because the residual claimant has the most to lose? If so, then we should focus on the three criteria relating to risk of loss (firm-specific investment, protection against non-payment, undiversified risk). Or is it because the residual claimant has the best capacity to exercise its vote effectively? If so, then we should focus on the three criteria that determine a claimant's relationship to the firm (bargaining power, express and implied contracts, and monitoring capacity). If more than one of these reasons explains why the vote follows the residual claim, the decision-maker would need to establish whether each of the residual claimant criteria matter equally, or if one consideration should be given greater weight than the others. In this way, the multicriteria assessment offers a framework to articulate and assess these tradeoffs.

In each of these examples, by designating the primary criteria to be used in residual claimant analysis, the group of stakeholders that are the primary residual claimant can be more precisely determined at any given time.¹³⁴ Furthermore, as the group that satisfies the primary criteria changes, the rights that attach to the residual claimant analysis should also change hands, leading to a more dynamic model of corporate governance.

CONCLUSION

The multicriteria assessment of corporate residual claimants presented in this Article is a useful tool for analyzing stakeholder relationships under changing conditions.

Notably, we are presently in the midst of a Digital Transformation, which is disrupting the core of how we live and work.¹³⁵ The World

¹³² *See id.*

¹³³ *See id.* at 368–70, 372–73.

¹³⁴ *See id.* at 372; Alchian & Demsetz, *supra* note 7, at 781–86, 794.

¹³⁵ SIEBEL, *supra* note 22.

Economic Forum estimates that the Digital Transformation could add up to \$100 trillion of new value in the next decade.¹³⁶

As we shift from a society that was primarily dependent on shareholders' financial investments to a society that is increasingly dependent on users' data and information, a single-criterion residual claimant analysis that looks only to shareholder profits will fail to fully and fairly represent the residual claims held by corporate stakeholders in the Digital Transformation era.

Instead, we should look to a multicriteria assessment of corporate residual claims which requires the analyst to consider and weigh multiple criteria to determine residual claimant status. The multicriteria assessment is a dynamic framework which can be used to reassign residual claimant status and associated legal rights and protections as underlying conditions change. By its very nature, the multicriteria assessment offers a pathway to shorten the gap of time by which law often lags behind the phenomenon it seeks to regulate.

¹³⁶ DIGITAL TRANSFORMATION INITIATIVE: UNLOCKING \$100 TRILLION FOR BUSINESS AND SOCIETY FROM DIGITAL TRANSFORMATION, WORLD ECONOMIC FORUM 2, 65 (May 2018), <http://reports.weforum.org/digital-transformation/wp-content/blogs.dir/94/mp/files/pages/files/dti-executive-summary-20180510.pdf> [<http://perma.cc/8G2X-L6XW>].