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THE PLACE OF WORKERS IN CORPORATE LAW

KENT GREENFIELD*

Workers have no role, or almost no role, in the dominant contemporary narrative of corporate law. Corporate law is primarily about shareholders, boards of directors and managers, and the relationships among them. Occasionally, corporate law concerns itself with bondholders and other creditors. Only rarely, however, does a typical corporate law course or a basic corporate law text pause to consider the relationship between the corporation and workers.[1] This is despite the fact that, by any account, workers provide essential inputs to a corporation's productive activities, and that the success of the business enterprise quite often turns on the success of the relationship between the corporation and those who are employed by it.

The justification for insulating the concerns of workers from the attention of corporate law is that such concerns are the subject of other areas of the law, most prominently labor law and employment law.

* Assistant Professor of Law, Boston College Law School. J.D., University of Chicago; A.B., Brown University. The author thanks Victor Brudney, James R. Repetti, Joseph William Singer and Aviam Soifer for helpful comments.

[1] Here and throughout this Article, "workers" refers to nonmanagerial employees. *See, e.g.*, WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 220–34 (7th ed. 1995) (in a casebook containing 13 chapters and over 1500 pages, no chapter is dedicated to the corporation's responsibilities towards its employees, and only 14 pages are dedicated to a section entitled "Interests Other than Maximization of the Shareholders' Economic Wealth"); JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 4–10 (4th ed. 1995) (a section entitled "A Scorecard of the Players" lists managers, directors and shareholders, but does not list employees); ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 558–72 (4th ed. 1990) (only 15 pages of 1200-page casebook dedicated to "'Social Responsibility' or the Lack Thereof").

Union matters are at the core of labor law; everyday employment relations are the province of employment law. Issues such as plant closings, if one were to judge by looking at the typical law school curriculum, do not provide many legal puzzles.[2] Plant closings and relocations *might* be covered in a labor law course, but usually only long enough for students to learn that companies have no duty to bargain over these actions.[3]

In the typical corporate law course, worries about workers are usually dismissed (or perhaps "downsized") quite early. This is typically accomplished through a discussion of *Dodge v. Ford Motor Co.*, a paradigm case that stands for the proposition that corporate law deems it impermissible for management (in that case, Henry Ford) to place the concerns of workers (in that case, for high wages and a modern workplace) on par with a concern for making profits for the shareholders (in that case, the Dodge brothers, who were seeking dividends to start a rival car company).[4] The Michigan Supreme Court frowned upon Ford's philanthropic impulses, declaring:

> *A business corporation is organized and carried on primarily for the profit of the stockholders.* The powers of the directors are to

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[2] This is notwithstanding the fact that much very good scholarship has focused, in one way or another, on issues arising out of plant closings. *See, e.g.*, Marleen A. O'Connor, *Promoting Economic Justice in Plant Closings: Exploring the Fiduciary/Contract Law Distinction to Enforce Implicit Employment Agreements*, *in* PROGRESSIVE CORPORATE LAW 219 (Lawrence E. Mitchell ed., 1995) [hereinafter O'Connor, *Economic Justice*]; Daniel A. Farber & John H. Matheson, *Beyond Promissory Estoppel: Contract Law and the "Invisible Handshake"*, 52 U. CHI. L. REV. 903, 938–42 (1985); Duncan Kennedy, *Distributive and Paternalistic Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563, 630 (1982); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991) [hereinafter O'Connor, *Nexus of Contracts*]; Joseph W. Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 611 (1988).

[3] Employers have a duty under the National Labor Relations Act to bargain with unions about the effects of a plant closing, but they need not negotiate over whether the plant should be closed in the first place. *See* First Nat'l Maintenance Corp. v. NLRB, 452 U.S. 666, 677–78 n.15 (1981); Katherine Van Wezel Stone, *The Legacy of Industrial Pluralism: The Tension Between Individual Employment Rights and the New Deal Collective Bargaining System*, 59 U. CHI. L. REV. 575, 588, 589 n.52 (1992). Moreover, according to Stone, effects bargaining generally takes place after the employer has made and implemented a decision, when the union no longer has leverage to protect its members. *See* Van Wezel Stone, *supra*, at 589 n.52. If the employer violates its obligation to engage in effects bargaining, the remedy for the violation is limited to back pay, and is typically calculated from five days after the date of the court or Board order until the time the parties reach either agreement or impasse, not to exceed the time the employee actually was out of work and not less than two weeks. *See* Transmarine Navigation Corp., 170 N.L.R.B. 389, 390 (1968). In effect, then, this means that when a violation is found, the employer quickly bargains to impasse and is liable for back pay for two weeks only. *See* Van Wezel Stone, *supra*, at 589 n.52 (citing, as an example, Yorke v. NLRB, 709 F.2d 1138, 1144–46 (7th Cir. 1983)).

[4] 170 N.W. 668 (Mich. 1919).

> be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.[5]

Classes then turn to the Business Judgment Rule, which, it is said, offers judicial deference with regard to the means but not the ends of business activity.[6] The relationship between workers and the corporation, and between workers and other stakeholders, is considered again, but only tangentially, when the class considers the Delaware takeover cases. One case, the *Unocal Corp. v. Mesa Petroleum Co.* decision,[7] allows directors of a company defending against a hostile takeover to consider a wide range of possible effects of the takeover, including a number of things that do not relate directly to shareholder wealth, such as "questions of illegality, [and] the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)."[8] But, as students learn, courts cut back on *Unocal* relatively quickly, especially in *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*[9] The *Revlon* court appeared to reinterpret *Unocal*, saying that the "board may have regard for various constituencies in discharging its responsibilities, *provided that there are rationally related benefits accruing to the stockholders.*"[10] In any event, the key lesson is that corporate law—and by extension corporate lawyers—do not bother much with the lives, interests and concerns of workers.

I try to change this a bit in my own corporate law class. We discuss, for example, a case arising from the closing of United States Steel factories in Youngstown, Ohio.[11] We address the workers' claims in the *Youngstown* case that the company's various representations about

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[5] *Id.* at 684 (emphasis added).

[6] For descriptions of the Business Judgment Rule, see 1 ERNEST FOLK ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 141.2.2.2 (3d ed., 1996); S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979); R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1339 (1993); Kent Greenfield & John E. Nilsson, *Gradgrind's Education: Using Dickens and Aristotle to Understand (and Replace?) the Business Judgment Rule*, 63 BROOK. L. REV. (forthcoming Spring 1998); Charles Hansen, *The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project*, 48 BUS. LAW. 1355 (1993).

[7] 493 A.2d 946, 955 (Del. 1985).

[8] *Id.*

[9] 506 A.2d 173 (Del. 1986).

[10] *Id.* at 182 (emphasis added).

[11] *See* Local 1330, United Steel Workers of Am. v. United States Steel Corp. ("*Youngstown*"), 631 F.2d 1264 (6th Cir. 1980).

keeping the plants open constituted enforceable promises.[12] We talk about the workers' assertions that over time they had developed something akin to a property interest in their jobs, which limited the company's ability to close the plants with impunity.[13] We explore the fact that workers are not protected by federal fraud laws (which would have limited the company's ability to mislead them about the probability of keeping the factories open), even though capital investors are so protected.[14] And, more generally, we discuss the corporation's duties in such plant closing situations; we analyze whether the directors and managers owe some duty to the workers other than those obligations created under noncorporate law. But even in my class, these abstract and idealistic notions are left behind as we turn to the nuts and bolts of the duties of care and loyalty, basic securities law and the takeover cases.

The taxonomy that insulates corporate law is artificial, to be sure, and it is also more than a bit ironic. The decisions that corporate managers make to guide the company on both the tactical and strategic level have a great deal to do with workers. It is odd for lawyers who seek to serve in the corporate setting to be taught, sometimes implicitly and sometimes explicitly, that workers are a subordinate concern. But this legal taxonomy is ironic for another reason. The economics of corporations have much to do with workers. In many ways, the theory of the firm—explaining why corporations exist at all—depends centrally on certain notions about workers.[15] In turn, the law of corporations (if we credit the dominant narrative again) is based largely on the economics of the corporation. Yet once we get to a description of the law itself, the workers have been left behind.

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[12] *See* Farber & Matheson, *supra* note 2, at 938–42.

[13] *See* Singer, *supra* note 2, at 614–22, 632–63.

[14] *See* Kent Greenfield, *The Unjustified Absence of Federal Fraud Protection in the Labor Market*, 107 YALE L.J. 715, 717–22 (1997).

[15] The modern theory of the corporation owes much to Ronald Coase, who theorized that the firm exists when it is more efficient to engage in intra-firm transactions (organized by direct authority) rather than market transactions. *See* R.H. COASE, THE FIRM THE MARKET AND THE LAW 33 (1988). Thus the theory of the firm depends much on insights about when it is most efficient for people to work together within a firm rather than through individually-negotiated contracts. Other writings on the economics of the firm turn on arguments about the consolidation of productive work. *See, e.g.*, Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972) (arguing that the firm exists to decrease the monitoring costs inherent in team production); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310–11 (1976) ("Contractual relations are the essence of the firm, not only with employees" but with others as well; the firm is a legal fiction that "serves as a focus for the complex process in which the conflicting objectives of individuals . . . are brought into equilibrium . . . .").

This Article critiques the place of workers within corporate law doctrine. The method by which this critique proceeds is by analyzing, and criticizing, the arguments for shareholder dominance. These arguments seek to justify a regime in which only shareholders have the right to elect members of the board of directors, and in which the management is held to owe fiduciary duties only to shareholders. My thesis is that implicit, and often incorrect, assumptions about workers form an important building block for corporate law theory and doctrine. Moreover, justifications for shareholder dominance—ownership, agency costs, the residual nature of their claims and inability to contract—are not as strong as generally proposed or often apply to workers as well.

Like others who are making related arguments in the current literature,[16] I seek to help justify the inclusion of workers' concerns and interests within the heart of the corporate enterprise. More specifically, I suggest that workers should have some kind of representation on the board of directors or have some role in electing directors, and that directors of companies should be held to have some kind of fiduciary duties to workers in the employ of their firm.[17] This Article is only a

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[16] *See, e.g.*, MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 16 (1995) (management should take into account the effect of corporate decisions and actions on all stakeholders who contribute firm-specific assets that are at risk in the enterprise); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 630–43 (1992) (stakeholders should have standing to sue directors when corporate action harms them); Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899 (1993) (corporate law should provide for employee representation on boards); Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45 (1991) (arguing for creation of fiduciary duties on behalf of employees, but suggesting that state stakeholders statutes do not create such duties); *see also* Margaret M. Blair & Lynn A. Stout, A Theory of Corporation Law as a Response to Contracting Problems in Team Production 6–7 (Sept. 26, 1997) (unpublished manuscript, on file with author) (corporate law, as a positive matter, recognizes directors' duties to non-shareholder stakeholders).

[17] Admittedly, the presence of fiduciary duties may not constrain directors' activities a great deal. Even though such duties now clearly flow toward the shareholders, it is quite difficult for shareholders to enforce them. Because of the Business Judgement Rule, courts tend to defer to the decisions of management unless egregiously wrong or clearly unfair. *See* Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 599–600 n.12 (1997) ("The level of care required by the fiduciary standard is low, and the quality of judgment required is even lower."). Moreover, a number of states, including Delaware, have provided or authorized exculpation from monetary damage for violation of the duty of care. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1996); N.Y. BUS. CORP. LAW § 402(b)(1) (McKinney Supp. 1997); REVISED MODEL BUSINESS CORP. ACT § 2.02(b)(4) (1994); *see also* Brudney, *supra*, at 600 n.12.

Nevertheless, especially if linked to other changes in corporate governance, fiduciary duties that run toward workers may have some impact in how corporations behave. It is likely, for example, that management would be held to a broader duty to disclose material information to

partial contribution to this endeavor. I do not here make the affirmative arguments essential to this normative project nor do I attempt to answer likely objections.[18] The focus of this Article is to question the affirmative claims of those who argue for shareholder dominance. This critical examination of these claims will anchor future work.

I. THE PRELIMINARY QUESTION OF OWNERSHIP

The justification for shareholder dominance that probably would leap most quickly to mind for many traditional corporate law scholars, and many lay people, is the notion that the shareholders are the owners of the corporation. Shareholders contribute the capital and hire the management. The corporation is merely the form through which the shareholders aggregate and utilize their property.[19] The authority of the corporation ultimately rests with them. A corporation is arranged to serve its shareholders first and foremost simply because the shareholders own it.

Yet, this concept of "ownership" no longer provides the dominant justification in corporate law scholarship for shareholder preeminence. As Jonathan Macey says: "[C]ontrary to popular belief, it is not particularly useful to think of corporations in terms of property

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employees. *See* Robert C. Clark, *Agency Costs versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 71 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (noting that an affirmative duty to disclose information is one of the "common attributes of the fiduciary relationship"); Greenfield, *supra* note 14, at 724, 729–30, 786 (describing how at common law the duty to disclose usually follows from the existence of fiduciary duties, though employers are not typically held to have fiduciary duties to their employees). Moreover, the existence of such duties would encourage directors to show that they had considered the interests of workers when they made important corporate decisions, such as closing a plant or merging with another company. *See* Greenfield & Nilsson, *supra* note 6 (describing how directors charged with fiduciary duties to a range of non-shareholder constituencies might discharge their duties).

[18] For example, I will not answer the assertion that directors cannot effectively serve two masters. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 38, 70 (1991) (making this claim); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 31–36 (1991) (stating that "too many masters" argument is overstated); O'Connor, *supra* note 16, at 958–59 (answering this claim). Nor will I answer the argument that the inclusion of workers in corporate governance will result in shirking on their part. *See* Stephen Bainbridge, Privately Ordered Participatory Management: An Organizational Failures Analysis 82 (Oct. 24, 1997) (unpublished manuscript, on file with author) (employees' lack of control is a way in which they bond their promise not to shirk).

[19] *See* Larry D. Soderquist & Robert P. Vecchio, *Reconciling Shareholders' Rights and Corporate Responsibility: New Guidelines for Management*, 1978 DUKE L.J. 819, 820 (1978) (describing traditional view).

rights."[20] Nicholas Wolfson emphasizes: "*Shareholders are not owners.*"[21] Nevertheless, property-based arguments for shareholder rights frequently appear in the popular press.[22] It is thus worth examining what the claim from property is and why it fails to provide a persuasive rationale for shareholder dominance in corporate law.

The property-centered justification for shareholder rights found voice in the work of Milton Friedman, the Nobel Prize-winning economist who once popularized the claim that the "one and only . . . social responsibility of business" was to increase its profits.[23] According to Friedman, the corporation is owned by the shareholders, and the

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[20] Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 175 (1989); *see also* JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 28–29 (3d ed. 1989) (contractarians "deny that any one class of participants (i.e., the shareholders) have a natural right to view themselves as the owners of the firm"); Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980) (abandoning "the typical presumption that a corporation has owners in any meaningful sense").

[21] NICHOLAS WOLFSON, THE MODERN CORPORATION: FREE MARKETS VERSUS REGULATION 40 (1984) (emphasis in original); *see also* Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 863 n.22 (1997) (ownership not a meaningful concept in contractarian analysis of corporation).

[22] A *Wall Street Journal* columnist, for example, used property-based language in defending AT&T's Chairman Robert Allen's decision to discharge 40,000 employees while accepting a $16.2 million compensation package. *See* Holman W. Jenkins, Jr., *Business World: 40,000 Job Cuts! Where Does He Get Off?*, WALL ST. J., Mar. 5, 1996, at A15. Allen was acting on behalf of "the owners," presumably the shareholders. *See id.* Because he owes duties to the "owners," Jenkins argues that Allen was right to refuse to "substitut[e] his own 'social conscience' for the interests of the people paying his salary." *Id.* The debate about whether AT&T should have discharged so many workers ought to be decided, according to this view, simply by reference to property rights. Another recent example comes from Albert Dunlap, the former Chairman and Chief Executive Officer of Scott Paper, who gained the nickname "Chainsaw Al" when he cut 11,000 jobs. *See Does America Still Work?* (Forum), HARPER'S, May 1996, at 35, 36. In a forum on corporate downsizing, Dunlap opposed arguments in favor of corporate social responsibility by using the duty- and rights-based language of property. *See id.* at 37, 44. It is, said Dunlap, the sole responsibility of corporate management to deliver value to the shareholders, who "own the corporation." *See id.* In fact, Dunlap has equated efforts to encourage corporate social responsibility with "socialism." *See Nightline: Interview with Albert Dunlap and Robert Reich* (ABC television broadcast, Feb. 14, 1996) (*available in* LEXIS, News Library, Script File). Consider also the comments of Walter M. Cabot, a corporate director and financial manager who participated in a 1991 conference at Stetson Law School about changes in corporate governance. *See* Walter M. Cabot, *The Free Market Promotes Long-Term Efficiency That Benefits All Stakeholders*, 21 STETSON L. REV. 245 (1991). Cabot asserted that "[i]ndividual stock ownership rights are fundamental rights, grounded in the U.S. Constitution" and described such rights as "sacred" and "inherent." *Id.* at 251; *see also id.* (implying that attempts to enact stakeholder statutes equate to socialism).

[23] Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES (magazine), Sept. 13, 1970, *reprinted in* MANAGERIAL DECISION MAKING AND ETHICAL VALUES: COURSE MODULE 1, 5 (Kenneth E. Goodpaster & Thomas R. Piper eds., 1989) [hereinafter Friedman, *Social Responsibility*]. Friedman added a caveat, however, saying that executives should

shareholders therefore have a right to expect that the managers of their property will, first and foremost, look out for them by making "as much money as possible."[24] Insofar as social concerns cause a corporate executive to reduce the corporation's returns to shareholders, the executive is spending "their" money and, in effect "imposing taxes" on shareholders.[25] This is impermissible because property should not be taken for the use of others without the owners' consent. Corporate charitable contributions, for example, should be impermissible because the "corporation is an instrument of the stockholders who own it . . . [and s]uch contributions should be made by the individuals who are the ultimate owners of property in society."[26] Indeed, Friedman equated loosening the corporation's duty to shareholders with "pure and unadulterated socialism."[27]

This reference to socialism was largely unexplained, but Friedman's meaning is not difficult to discern. Socialism, in Friedman's view, is theft of the personal right to hold private property and rejection of a private economic sphere. Adjustment in the rules of corporate law is an encroachment into this private sphere. For the state to broaden a corporation's responsibilities beyond the shareholder-owners would extract the owners' private resources for public purposes and would make private property the instrument of the state. This, apparently, is as much a violation of the rights of property ownership as, say, state-mandated cooperative farms.

The property-based justification for shareholder dominance begs the question, of course. Asking whether directors should owe fiduciary duties to workers or whether workers should have a say in electing directors is, in one sense, simply asking again whether shareholders should "own" the firm. One cannot answer this question simply by saying that the shareholders own the firm.[28] At heart, the property-

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make as much money as possible "while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom." *Id.* at 2. He did not explain what he meant by this phrase. Later in the same piece he stated the caveat differently, saying that the profit-maximizing goal should be pursued while "staying within the rules of the game," explained as "open and free competition without deception or fraud." *Id.* at 5; *see also* MILTON FRIEDMAN, CAPITALISM AND FREEDOM 133 (1962) [hereinafter FRIEDMAN, CAPITALISM AND FREEDOM]; CHRISTOPHER D. STONE, WHERE THE LAW ENDS 75–76 (1975) (discussing caveat).

[24] Friedman, *Social Responsibility*, *supra* note 23, at 2.

[25] *See id.*

[26] FRIEDMAN, CAPITALISM AND FREEDOM, *supra* note 23, at 135.

[27] Friedman, *Social Responsibility*, *supra* note 23, at 1; *see also supra* note 22 (noting others who equated corporate social responsibility with socialism).

[28] *See* BLAIR, *supra* note 16, at 224 (argument that shareholders own the corporation and thus should be able to control it "is simply circular logic"); Singer, *supra* note 2, at 637–38 ("To assume that we can know who property owners are, and to assume that once we have identified them their rights follow as a matter of course, is to assume what needs to be decided.").

based conception attempts to answer the question of why shareholders are dominant in corporate law simply by reference to the fact that they are dominant in corporate law.

Perhaps Friedman and other property theorists should be taken to offer a more subtle argument. They might be said to argue that shareholders certainly have some property interest in the firm, usually represented by the shares they hold, and that this ownership interest should not be limited. With ownership comes control.[29] To require directors to take workers' interests into account would limit shareholders' property rights, and such limitation is inconsistent with the very nature of those rights.

This argument, too, is unpersuasive. It is founded on a simplistic notion of the sanctity and indivisibility of property rights. Notwithstanding the "illusion of absoluteness" that accompanies much property-rights rhetoric, property has always been subject to reasonable regulation.[30] An adjustment in corporate governance is just that—a regulation.[31] Even if shareholders are considered the owners of the corporation, one would have to provide a much more sophisticated defense of why such ownership gives absolute power to shareholders to block changes in corporate governance.

Few truly believe that ownership of corporations brings with it absolute power to defend against adjustments in the corporate enterprise. The simplicity of the claim that an adjustment in corporate governance offends property rights is highlighted when one compares it to debates about other public policy choices that affect business enterprises. The minimum wage provides a good example. In 1996, the U.S. Congress increased the minimum wage from $4.25 to $5.15 per hour.[32] Note the similarities of an increase in the minimum wage with, say, a "stakeholder statute" requiring corporate directors to consider the needs and interests of employees when making corporate decisions.[33] Both proposals may well impose costs on the corporation

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[29] *See* BLAIR, *supra* note 16, at 223–24 (relating this argument as one of the principal arguments for shareholder control).

[30] *See* MARY ANN GLENDON, RIGHTS TALK: THE IMPOVERISHMENT OF POLITICAL DISCOURSE 18, 20 (1991).

[31] *See* Kent Greenfield, *From Rights to Regulation in Corporate Law*, *in* 2 PERSPECTIVES ON COMPANY LAW 1, 21–25 (Fiona M. Patfield ed., 1997) (arguing that corporate law should be seen as a branch of public law rather than private law).

[32] *See* Hilary Stout, *Clinton Signs Measure Raising Minimum Wage*, WALL ST. J., Aug. 21, 1996, at A16.

[33] A majority of states have adopted stakeholder statutes, which allow corporate directors to take the interests of non-shareholder stakeholders into account when making decisions for the corporation. *See* Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163, 163–65 (1991) (describing Pennsyl-

that result in a decrease in shareholder return. Both proposals restrict the internal decisionmaking of the corporation—the minimum wage statute by disallowing labor contracts offering wages below the statutory minimum, the stakeholder statute by disallowing agreements between management and shareholders that include a promise by management to maximize returns without concern for the firm's employees. Both proposals impose mandates on the corporation that were not necessarily assumed by the shareholders when they purchased their shares.

In the debate about the minimum wage, however, an argument that a legislated increase is impermissible because the shareholders "own the corporation" seems unresponsive.[34] People seem to understand that the debate about an increase in the minimum wage turns on, and should turn on, the effect of such an increase on workers, companies and the economy as a whole.[35] A shared assumption is that

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vania statute). Only Connecticut's statute includes language that requires, rather than permits, directors to consider non-shareholder stakeholders. *See* CONN. GEN. STAT. ANN. § 33-756 (West 1997). According to Charles Hansen, only Iowa, Indiana and Pennsylvania (in addition to Connecticut) permit directors to place other constituencies on the same footing as stockholders. *See* Charles Hansen, *Other Constituency Statutes: A Search for Perspective*, 46 BUS. LAW. 1355, 1370, 1375 (1991); *see also* Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1411-12 (1993); Wallman, *supra*, at 194-96. These statutes were adopted largely to increase corporations' abilities to fight hostile takeovers by lessening the duty of directors to accept the highest bid for the company. *See* Greenfield & Nilsson, *supra* note 6. It is still unclear whether these statutes will have much utility in encouraging a broader view of corporate social responsibility outside the takeover context, especially because employees and other stakeholders do not typically have standing to enforce the stakeholder statutes. In fact, several statutes explicitly deny that they create any enforceable duty to the constituencies whose interests may be considered. *See, e.g.*, GA. CODE ANN. § 14-2-202(b)(5) (1991) (declaring that the director's authority is discretionary and "shall not be deemed to provide to any constituency any right to be considered"); N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1997) (providing that "nothing in this paragraph shall create any duties owed by any director to any person or entity to consider or afford any particular weight" to non-shareholder considerations or abrogate any existing directorial duties); 15 PA. CONS. STAT. ANN. § 1717 (West 1995) (limiting standing to shareholders).

The scholarship on stakeholder statutes is fairly extensive. In addition to the articles above, consider David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, *in* PROGRESSIVE CORPORATE LAW, *supra* note 2, at 1; William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385 (1990); James J. Hanks, Jr., *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97 (1991); Macey, *supra* note 18, at 33-35; Morey W. McDaniel, *Shareholders and Stakeholders*, 21 STETSON L. REV. 121 (1991). For a compilation of stakeholder statutes, see Symposium, *Corporate Malaise—Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 279 app. (1991).

[34] I have argued elsewhere that such ownership rhetoric is a throwback to the kind of rights-based discourse prevalent during the *Lochner* era. *See* Greenfield, *supra* note 31, at 11, 17-19 (noting similarities between rights-based assumptions of many corporate law scholars and the rights-based assumptions of the Supreme Court in *Lochner v. New York*, 198 U.S. 45 (1905)).

[35] For example, during the debate on the minimum wage, *The Wall Street Journal*, a vigorous opponent of the minimum wage increase, published views of a number of economists about the

the "rights" of the shareholders are beside the point in the debate.[36] The language of property rights ought to have no greater place in a discussion of proposals to change the rules of corporate governance, even though as a matter of fact it is a common part of at least the popular discourse.

Another way in which the ownership justification for shareholder dominance falls short is in its failure to take note of the fact that the law has long recognized that "ownership" assumes obligations as well as rights.[37] The broad principle that one should not use one's property to inflict harm on others has been "applied routinely" in U.S. courts since the nation's beginning.[38] The Supreme Court recognized over 150 years ago that "[w]hile the rights of private property are sacredly guarded, we must not forget that the community also have [sic] rights."[39] A property owner cannot burn noxious trash in her backyard so as to cause a nuisance to her neighbors, for example, and a factory owner may not operate a factory that is unreasonably dangerous to the employees working there. There is little in the nature of the ownership claim itself that differentiates these obligations from, for example, the duty to take into account the interests of long-term workers before deciding to close a factory.[40] It is unhelpful for Friedman and others to use the metaphors of property as a normative argument for shareholder dominance without an explanation of why some aspects of the metaphor are relevant and others are not.

An additional, fundamental objection to Friedman's property-based view asks why, in any event, shareholders are deemed to be the owners of the corporation. To be sure, shareholders own their shares. But bondholders own their bonds, suppliers their inventory and workers their labor. They all contribute what they own to the corporate enterprise. As Margaret Blair and Lynn Stout write, "shareholders are not the only group that provides essential, specialized inputs into public corporations."[41] Among these contributors, no one is making a

issue. *Minimum Wage vs. Supply and Demand*, WALL ST. J., Apr. 24, 1996, at A14. These economists analyzed the proposed increase in economic terms, not in terms of the rights of the shareholders of the companies that would be required to pay the higher wages. *See id.* No economist said that raising the minimum wage was impermissible because it forced managers to give away money that "belongs" to the shareholders. *See id.*

[36] *See* Editorial, *Repeal the Minimum Wage*, WALL ST. J., Apr. 29, 1996, at A22 (opposing an increase in the minimum wage but not raising the issue of the ownership rights of shareholders).

[37] The clearest voice in the academy making this point is Joseph Singer. *See, e.g.*, Joseph W. Singer, *Rent*, 39 B.C. L. REV. 1 (1997); Singer, *supra* note 2.

[38] *See* GLENDON, *supra* note 30, at 25.

[39] *Id.* at 26 (citing Charles River Bridge v. Warren Bridge, 36 U.S. (11 Pet.) 420, 548 (1837)).

[40] *See* Singer, *supra* note 2, at 659–63.

[41] Blair & Stout, *supra* note 16, at 6.

charitable act; they each expect to earn some return on their contribution. And the input of each is essential to the success of the firm. To say that shareholders are the only "owners" is to say that there is something inherent in the act of contributing money to buy shares—or in the definition of "ownership"—that distinguishes that act from the act of contributing money to buy bonds issued by the company, or contributing raw materials to be refined by the company or contributing labor for the company to use.

Moreover, as Joseph Singer has observed, the law frequently deems property interests to have been created as the result of relationships and understandings on which people rely over time.[42] Examples include rules surrounding "adverse possession, prescriptive easements, public rights of access to public property, tenants' rights, equitable division of property on divorce, [and] welfare rights."[43] Singer argues that workers often develop reliance interests in their jobs analogous to other kinds of reliance interests that are recognized by the law.[44] Singer states that:

> Rather than seeing the corporation and the workers in isolation, and assuming that the corporation has absolute freedom to dispose of "its" property as it sees fit we can see the corporation and the workers as together having established and relied on long-standing relations with each other in creating a common enterprise. The rights of the members of the common enterprise cannot be fully articulated by reference to ownership rights defined *a priori* or by the explicit terms of written contracts. If workers are considered to be part of the corporation, rather than factors of production or hired hands, our analysis of property rights changes.[45]

Thus, if property rights are the touchstone for corporate law, workers can be seen as having cognizable property interests in the firm and in their jobs.

Even on property grounds, therefore, we ought to be critical of the rule of shareholder dominance. As mentioned above, however, the argument for shareholder dominance from notions of property is no longer the leading explanation within corporate law. Instead, the dominant paradigm now depends on contract principles: "[T]he modern

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[42] *See generally* Singer, *supra* note 2, at 622, 663–77.
[43] *Id.* at 622.
[44] *See id.* at 621, 656.
[45] *Id.* at 657.

theory of the firm tells us that, while each participant in the corporate enterprise owns certain inputs (labor, capital, machinery, inventory), the firm itself is nothing but a web of contractual relationships among these various production factors."[46] The contractarians thus believe that the "relevant inquiry" does not concern "who owns the corporation."[47] Instead, the dominant explanations today relate to agency costs, residual claims, contracting problems and general notions of efficiency. The remainder of this Article will analyze these arguments.

II. The Problems of Agency

A. *Shareholders and Agency Costs*

Many contractarians believe that the fundamental concern of corporate law is "agency costs," the issue of how shareholders can reduce the costs of delegating control over financial capital to corporate managers.[48] This theme traces its roots to the work of Adolf Berle and Gardiner Means, who in 1932 published their famous book, *The Modern Corporation and Private Property*.[49] Their thesis was that the key problem in corporate law was the separation of ownership and control.[50] It has been posited that the many and dispersed owners of the modern corporation, each of whom has contributed only a small percentage of the company's financial capital, collectively do not have the incentive to control corporate management effectively.[51] Managers thus are able to engage in activities that are not necessarily in the interests of the shareholders. While contractarians would not agree that shareholders are powerless, many do believe that the "fundamental insight of the Berle and Means theory—that there are costs of

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[46] Macey, *supra* note 20, at 175.

[47] *Id.*; *see also* David Millon, *Theories of the Corporation*, 1990 Duke L.J. 201, 229 ("The new theorists also reject the utility of the conception of shareholders as 'owners' of the corporation, preferring instead to describe shareholders as only one among the various suppliers of 'inputs,' whose rights are determined by the interrelation of the various contracts that define and constitute the corporate enterprise.").

[48] *See, e.g.*, Easterbrook & Fischel, *supra* note 18, at 9–11, 14–15; Alchian & Demsetz, *supra* note 15, at 778, 791–93 (the key element of the firm is the "centralized contractual agent in a team production process"); Fama, *supra* note 20, at 289 (abandoning "the typical presumption that a corporation has owners in any meaningful sense"); Jensen & Meckling, *supra* note 15, at 308–10 (problems of the corporate form are essentially agency problems).

[49] Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (1932).

[50] *See id.* at 124.

[51] *See* Henry N. Butler & Larry E. Ribstein, The Corporation and the Constitution 2 (1995).

delegating control over financial capital to corporate managers—provides the cornerstone of the contractual theory of the corporation."[52]

For many contractarians, the key problem is thus that managers are "less than perfect agents" of the shareholders.[53] Henry Butler and Larry Ribstein identify a number of potential conflicts between managers and shareholders, including differences in effort, time horizon and risk aversion.[54] Effort is a concern because managers do not reap all the gain of their work if they succeed and do not suffer all of the losses if they fail; thus they may not work as hard for the corporation as the shareholders would like.[55] "Horizon" refers to the point that a manager's interest will diverge even more from that of the shareholders as the manager approaches retirement or prepares to leave the firm for other reasons. Risk aversion is another point of difference, because diversified shareholders are risk neutral with regard to individual securities in their portfolios, whereas managers, wanting to retain their jobs, are more likely to make decisions to minimize the risk of firm bankruptcy.[56] In other words, managers tend to make decisions that are insufficiently risky from the shareholders' perspective.

According to many contractarians, the purpose of corporate governance, and of corporate law, is to reduce these agency costs.[57] Contractarians observe that the law and the market have worked together to instill a set of protections for shareholders.[58] One such protection is the product market: if the firm is run inefficiently, it will have a difficult time selling its products (whether goods or services) on competitive terms.[59] If managers want to keep their jobs, they will try to improve the firm's efficiency.

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[52] *Id.* at 2–3.

[53] *Id.* at 3; *see also* John W. Pratt & Richard J. Zeckhauser, *Principles and Agents: An Overview*, *in* PRINCIPLES AND AGENTS: THE STRUCTURE OF BUSINESS, *supra* note 17, at 2–3 (describing the agency relationship). Friedman also relied on the agency metaphor to argue that corporate managers may not engage in corporate social responsibility activities. "In a free-enterprise, private property system," said Friedman, "a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires . . . ." Friedman, *Social Responsibility*, *supra* note 23, at 2. Friedman asserted that the "whole justification" for allowing managers to be selected by shareholders was that the managers are agents "serving the interests of [their] principal." *Id.* at 3.

[54] *See* BUTLER & RIBSTEIN, *supra* note 51, at 3. They also identify under-leveraging and dividend payouts as issues in which the interests of shareholders and managers differ.

[55] *See* Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1262 (1982).

[56] *See* BUTLER & RIBSTEIN, *supra* note 51, at 3.

[57] *See* Fischel, *supra* note 55, at 1261–65.

[58] *See id.* at 1264.

[59] *See id.*

Perhaps the most important market protection is the efficient capital market, which rapidly incorporates information about a company into the prices for that firm's securities.[60] If corporate management pursues actions that harm investors, the price of the firm's securities will fall in the capital market. The efficient market also allows investors to sell their interest in firms whenever they hear that managers are failing to maximize profits. The liquidity of the security means that existing shareholders can dispose of their security before they suffer significant harm from managers' actions. Potential shareholders are protected as well, because it is assumed that the price of a firm's security will accurately reflect the management's diligence in maximizing returns for the shareholders.

If management is inefficient, the price of shares will tend to be less than what it would be under efficient management. This will make a takeover of the company cheaper and more likely.[61] Because takeovers usually result in a change in management, a manager who wants to keep her job will work to maintain a high share price. An efficient capital market thus reduces agency costs by disciplining managers through the possibility of takeovers. This is the so-called market for corporate control.

There is also an employment market for corporate managers themselves.[62] If managers are considered good at their jobs, i.e., if they maximize the share price of their firms, they will often be compensated either directly or indirectly.[63] Perhaps other shareholder-dominated firms will try to entice them away, or their present firm links their compensation package to overall firm profitability. If managers are seen to be doing poorly, their personal wealth will likely decrease over time. This market for the managers themselves thus decreases the difference between the interests of the shareholders and the managers.

Shareholders as a group are also protected by the presence of stockholders who own sizeable blocks of shares.[64] These shareholders—usually large institutions—have both the incentive and the ability to monitor the activities and performance of corporate management in ways other than simply through the price of the firms' shares.[65] When

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[60] *See* BUTLER & RIBSTEIN, *supra* note 51, at 5, 147 n.8 (describing market efficiency theory, citing Eugene Fama, *Random Walks in Stock Market Prices*, 21 FIN. ANAL. J. 55 (1965)). For a general review of the efficient capital market hypothesis, see RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 135–81 (2d ed. 1995).

[61] *See* Fischel, *supra* note 55, at 1264.

[62] *See* BUTLER & RIBSTEIN, *supra* note 51, at 9.

[63] *See* Fischel, *supra* note 55, at 1263.

[64] *See* BUTLER & RIBSTEIN, *supra* note 51, at 9.

[65] In 1994, 56% of the shares of the 1000 largest U.S. corporations were held by institutions.

Fidelity telephones, even the head of General Electric is likely to pick up the phone. Individual, small shareholders are protected by being able to free ride on the monitoring done by larger shareholders.

According to conventional corporate law doctrine, however, all these market devices, while powerful, are not sufficient to reduce agency costs to the optimal level.[66] The law must also step in by imposing fiduciary duties on management to serve the shareholders. Shareholders desire these protections because market protections are imperfect. Fiduciary duties thus theoretically cause managers to be reluctant to shirk or self-deal because of the risk that such behavior could subject them to costly litigation. These duties are seen as "gap-fillers,"[67] in that they impose duties on management in the absence of explicit agreements. In fact, these legally-imposed duties are seen as efficient alternatives to "writing lengthy and complicated contracts."[68] To be efficient, the law should (and does, it is claimed) "approximate the bargain that investors and managers would reach if transaction costs were zero."[69] It is central to the contractarians' view, then, that shareholders and managers are, and should be, able to contract around these legal duties if they reduce agency difficulties at too high a cost.[70]

In the view of the contractarians, therefore, fiduciary duties are essentially a market protection, too. The protection is a result of the implicit contract between the shareholders and managers, which provides that if managers do not adequately serve the interests of the shareholders, and other forces do not control such behavior, the shareholders can go to court for redress. Importantly, shareholders can also discipline management through the power of voting their shares. If they believe new management could do better, they can vote for new board members.[71]

In any event, the key rationale for the presence of a judicial remedy and for shareholder voting rights is the desire to reduce the difference between shareholder and managerial interests. This is taken

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Moreover, most of the shares held by institutional investors are held by a relatively small number of all such institutions. *See* CARY & EISENBERG, *supra* note 1, at 244–45.

[66] *See* BUTLER & RIBSTEIN, *supra* note 51, at 6 (noting that the optimal level of agency costs is unlikely to be zero).

[67] *See id.* at 12.

[68] Fischel, *supra* note 55, at 1264.

[69] *Id.*

[70] *See, e.g.*, BUTLER & RIBSTEIN, *supra* note 51, at 12. Note, however, that even though some states have adopted statutory provisions allowing companies in effect to waive the duty of care, these statutes do not extend to an allowance for waiving the duty of loyalty. *See supra* note 17.

[71] *See* BUTLER & RIBSTEIN, *supra* note 51, at 8. Even if shareholders in fact rarely vote for a change in management, the fact that they have the power to do so reduces the likelihood that management will shirk or self-deal.

as a given. If agency costs are not reduced, it is assumed that shareholders will choose to place their financial capital in other financial vehicles (insured bank accounts, for example, or bonds protected through covenants) or they will demand higher or more secure dividends.

B. *Workers and Agency Costs*

It is assumed that the purpose of corporate law is to reduce agency costs between managers and *shareholders*, and not other stakeholders such as employees. At first glance, this is merely stating the obvious. But let us consider the role of employees and agency costs more closely.

Few have recognized that employees have "agency costs" of their own, in the sense that they must depend on the actions of management even though their interests do not always coincide. Admittedly, it is unusual to speak in terms of agency costs from the workers' perspective, since agency *law* typically concerns itself with the problems associated with the difficulties managers/principals face in ensuring that employees/agents satisfy the desires of the manager/principal. But the problem is mostly semantic. There can be "agency *costs*" in relationships that do not meet the legal definition of a principal/agent. In any ongoing contractual relationship, there are costs associated with monitoring to ensure that the other contracting party is satisfying her obligations under the contract.[72]

Employees in a firm, in fact, must bear certain monitoring costs—"agency costs"—associated with making sure that the firm's management is keeping their interests at heart. One might claim here that workers do not have the "right" to have this concern, because managers are not their servants. But once we remove ourselves from the realm of property and adjudge the corporate form in contractual terms, workers have (at least) whatever "rights" they bargain for successfully. What is important at this juncture is to notice that workers have some of the same problems as shareholders: they contribute something of value to management and they must depend on management both to maximize the return on that input and to share that return with them.

Workers, like shareholders, give up control over something of worth when they invest it in the firm. In the case of shareholders, it is

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[72] *See* Pratt & Zeckhauser, *supra* note 53, at 2 ("Whenever one individual depends on the action of another, an *agency relationship* arises." (emphasis in original)); *id.* ("In many contexts, the agency relationship may be reciprocal."); *see also* Jensen & Meckling, *supra* note 15, at 310 ("Contractual relationships are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc. The problem of agency costs and monitoring exists for all of these contracts . . . .").

money. In the case of workers, it is skill, time and effort. In both cases, the contributors' willingness to part with the resource depends on an assessment that they will receive more by contributing it than by withholding it. Shareholders must determine that they will make more money or suffer less risk by holding their money in stock than in some other vehicle. Workers must determine that they will receive more (in terms of money, job security, benefits, working conditions, training, safety or pleasure) than they would receive by working elsewhere or for themselves, or by engaging in leisure activities.[73]

The judgment of both the shareholders and the workers depends on their assessment of management. As Greg Dow and Louis Putterman declare, "it is unclear why equity investors have a greater need for safeguards against managerial abuse than employees."[74] Shareholders believe that buying shares is better than putting money in savings accounts, for example, because shareholders believe that managers can utilize the productive capacity of the firm to make a better, or safer, return than other possible investments. Workers show up to work because they believe that the managers can organize their labor and other resources so that they can be more productive than the sum of their productiveness as individuals, and that they will share in the gain. Like shareholders, workers depend on the care, skill and good faith of the management. If the managers do not take care, or are stupid, or look after themselves only, both the shareholders and the workers will be harmed. The shareholders will receive less return on their investment. The workers will have jobs that are less attractive—lower paying, less secure, less safe. So both parties must take care to reduce the "agency costs" of giving over control of something they value to management.

Of course there are ways both shareholders and workers can reduce these agency costs. As discussed above, the market for corporate control and the ease of selling stock in an efficient and liquid market assists shareholders in holding managers accountable to them.[75] The presence of large, institutional shareholders who have the ability and incentive to monitor closely managers' performance means that small, individual shareholders are protected.[76]

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[73] *See* Blair & Stout, *supra* note 16, at 25–26 (positing that the directors are "hired" by those who make up the firm, including employees, to mediate among their interests: "it is no longer obvious that employees should be viewed as agents of the managers to whom they report").

[74] Greg Dow & Louis Putterman, Why Capital (Usually) Hires Labor: An Assessment of Proposed Explanations, Department of Economics Discussion Papers, Simon Fraser Univ. 32 (Nov. 1996 draft) (on file with author).

[75] *See supra* notes 60, 61.

[76] *See supra* notes 64, 65.

Workers have fewer market protections. To be sure, they are engaged with the work of the company and with management every day. A shareholder gives over her money and does not see where it is put to use, but a worker knows better where his labor, skill and effort are allocated. He may therefore better monitor how his own contribution is being used. Moreover, a worker can actually see important indicators of management strategy and performance: levels of maintenance; size of inventories; and managers' mood and demeanor.

But there is much, and much that is important, that a worker cannot see, and much that shareholders can see better. Workers do not, as a rule, have the same access to senior management that at least large institutional shareholders enjoy. Workers are not represented on the board of directors and are not privy to important strategic discussions that affect the company as a whole. Workers are not protected, as shareholders are, by a federal regime of fraud protection and mandated affirmative disclosure of facts material to them.[77] Indeed, there are huge informational asymmetries between employers and workers. Workers, for example, cannot know very well about their impact on firm profitability.[78] (In fact, there are numerous examples of firms misleading employees about this very matter.)[79]

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[77] *See* Greenfield, *supra* note 14.

[78] *See* O'Connor, *supra* note 16, at 924.

[79] In the *Youngstown* case, for example, management continuously assured workers that their plants were profitable and that the company would not close the plants as long as they remained so. *See* Local 1330, United Steel Workers of Am. v. United States Steel Corp., 631 F.2d 1264, 1270–77 (6th Cir. 1980). In the end, the company closed the plants saying that the plants were not profitable, apparently using a different definition of "profit" than they had used before. *See id.* at 1279 (reviewing plaintiffs' argument that the version of "profitability" the company used in setting goals for employees was different from the version the company used in deciding to close the plants); *see also id.* at 1276 (setting out company's representation to employees that plants were "presently profitable" as of May 1979); *id.* at 1273 (describing company chairman's statement in June 1979 that "[t]he Youngstown plant is profitable"); *id.* (relating company's representation to employees in November 1979 that the "Ohio Works has been profitable"); *cf. id.* at 1278 (reviewing Chairman's testimony before the district court, in which he claimed that as of October 1979 that the plants had lost $300,000 for the year).

A more recent example comes from the Hathaway shirt factory in Waterville, Maine, where a mostly female work force has been sewing Hathaway shirts for over 150 years. *See* Adam Zagorin, *Short-Shirted in Maine*, TIME, June 3, 1996, at 58. In early 1995, Linda Wachner, the Chief Executive Officer of The Warnaco Group, Inc., Hathaway's parent company, went to Waterville to quell fears of an imminent plant closing. Sales were booming in Warnaco's various brands, and the stock price was soaring. *See id.*; *see also Industry-by-Industry, Who Leads the Field in Shareholder Returns*, WALL ST. J., Feb. 27, 1997, at R4 (Warnaco's stock's five-year average return was the second best within its industry group). According to one account, Wachner assured Waterville workers that she "would not close the plant" if the employees "would do quality work and bring the cost of the shirt down." Sara Rimer, *Fall of a Shirtmaking Giant Shakes Its Hometown*, N.Y. TIMES, May 15, 1996, at A14. Afterward, the employees forfeited a raise to help pay for productivity consultants for the plant, and the employees' union persuaded the company to adopt a joint labor-management program to address workplace problems and to improve productivity.

Moreover, even when workers see evidence that the management is not acting in their best interest, there is less they can do about it. Workers can quit, of course, just as shareholders can sell. But the cost of quitting is much higher for a worker than the cost of selling for a shareholder.[80] The cost of selling shares in a very liquid market is typically quite low, both in terms of transaction costs and in terms of finding a suitable replacement investment. Furthermore, a diversified shareholder will suffer the cost of a company's poor management in only a small percentage of her portfolio. A worker, however, must bear high costs when she quits for several reasons. Because of the nature of the input, a worker will be less "diversified" than a typical shareholder. A worker will tend to hold only one or two jobs; a shareholder may own scores, even hundreds, of stocks.[81] Any harm suffered because of poor management thus will be felt more strongly by the worker than the shareholder. The cost of moving from one job to another is also much higher than selling one stock and buying another. Labor is much less mobile than capital, and the labor market is less liquid and less efficient than the capital market.[82] It will take longer for a worker to find a substitute job, and the substitute is less likely to be close to what the worker had previously.

Both these harms will be felt even more if the worker has developed firm-specific skills. Such skills make a worker more valuable to her present employer, but also make her more vulnerable to a firm's opportunistic behavior.[83] More specifically, after workers develop firm-specific skills, the "exit option"—going to work for a different company—becomes more costly. The firm, then, often has greater incentives to renege on any implicit agreements of job security or wage rates

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See Rimer, *supra*, at A14; *Union Efforts to Increase Productivity Not Enough to Keep Warnaco Plant Open*, Daily Lab. Rep. (BNA) No. 98, at D-9 (May 21, 1996) [hereinafter *Union Efforts*]. By March 1996, the employees had doubled the factory's productivity. *See* Rimer, *supra*, at A14; *Union Efforts*, *supra*, at D-9. The productivity consultant claimed that the employees had "turned this plant around." Rimer, *supra*, at A14. Warnaco, in the meantime, recorded unprecedented profits. *See Union Efforts*, *supra*, at D-9. On May 6, 1996, however, Wachner announced that Warnaco would quit making the Hathaway line and either sell or scrap the Waterville plant. *See* Rimer, *supra*, at A14; *Union Efforts*, *supra*, at D-9. Hathaway shirts were said to be not keeping up with Warnaco's other, more profitable product lines. *See* Rachel Spevack, *Warnaco Pulling Plug on the Patch*, Daily News Rec., May 7, 1996, at 1. *See generally* Greenfield, *supra* note 14, at 721 n.26 (discussing cases).

[80] *See* Dow & Putterman, *supra* note 74, at 32 ("[W]orkers cannot easily diversify by holding more than one job at the same time, and . . . switching jobs generally involves significant costs . . . ."); Greenfield, *supra* note 14, at 749–50; Van Wezel Stone, *supra* note 16, at 46–47.

[81] *See* O'Connor, *supra* note 16, at 925.

[82] *See* Greenfield, *supra* note 14, at 749–50; O'Connor, *supra* note 16, at 924–25.

[83] *See* Greenfield, *supra* note 14, at 779–80; Macey, *supra* note 20, at 191–92 (noting that the development of firm-specific skills by rank-and-file workers exposes them to possible exploitation); O'Connor, *supra* note 16, at 909–10, 916–17.

or working conditions, because its management knows that the total compensation package (including wages, security and working conditions) the firm's workers would receive elsewhere is equal to that received by workers without such firm-specific skills.[84]

All this is to say that shareholders certainly are not the only ones who need to worry that management is taking their interests to heart. Workers, too, must be concerned that the management will take care and be loyal to the enterprise. The usual story about shareholders needing and wanting to reduce agency costs inherent in their contribution of their productive input applies, in many ways, to workers as well. And workers are less protected by market mechanisms than are shareholders.

It is not clear, then, why corporate law should step in to reduce further the agency costs between managers and shareholders yet not between managers and workers. The presence of fiduciary duties that run only to shareholders and voting rights held only by shareholders cannot be explained by the presence of agency costs alone. There must be an additional component of the argument—something that relies on the fact that shareholders already get more protection from the market than do workers. The argument might be that corporate law should reinforce what the market already protects and should not reinforce what the market does not protect. Yet this is a provocative claim, and it is hardly obvious. It is actually an argument not at all about agency costs but about the role of law. This argument would suggest that the law should bolster the interests of those market participants who already exercise market power. In the last analysis, this argument holds that the market is the best adjudicant of public policy, and efficiency the key determinant of good governance. This claim is considered in Part V.

III. The Corporation and Residual Claims

A. *The Residual Nature of Shareholders' Claims*

Many corporate law writings make the point that the shareholders' equity stake in a firm is in the nature of a residual claim.[85] That is to say that within the very definition of a common share is the notion that its holder is entitled to the value of whatever is left after all others with claims against the company are satisfied. When the company is

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[84] *See* Macey, *supra* note 20, at 191–92 (illustrating how employers can exploit workers who have developed firm-specific skills); O'Connor, *supra* note 16, at 923.

[85] *See* Easterbrook & Fischel, *supra* note 18, at 10–11, 67.

worth less than the sum of all the prior claims, the common shares are worth nothing. When the company is worth more than the value of the prior claims, the common shareholders are entitled to the entire remaining, or residual, value.

One might argue that shareholders deserve to be dominant within the corporate structure because of this residual interest, because that is what having a residual interest *means*. Ownership is by definition the residual claim. Shareholders, because they accept this residual claim, are the owners of the firm. The firm is thus properly designed to serve its owners.

The difficulty with this argument is that, like the more simplistic argument from the nature of ownership itself,[86] it includes the answer in the assumption that frames the question. There is nothing inherent in the nature of a residual claim that means that its holders' interest should be maximized above all others.[87] One can certainly imagine, for example, a company that acknowledges responsibilities to a number of stakeholders, but still issues common stock that constitutes residual claims on the financial surplus of the company. Said another way, one can imagine a corporate "contract" that does not link the residual claim on financial assets with a sole claim on the attentions of the directors.[88]

A more nuanced argument for the dominance of the shareholders depends instead on the assertion that the residual nature of the shareholders' claim makes the shareholders the best protectors of the firms' interest.[89] That is, the shareholders' interests and the interests of the enterprise as a whole can be said to be more closely aligned than are the interests of other claimants and the firm. The residual claimants' interests conflate with those of the firm because, as claimants on what is left after all other claims are paid, they want the company to maximize long-run profits, which in turn maximizes the value of their

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[86] *See supra* notes 23 to 28 and accompanying text.

[87] *See* Macey, *supra* note 18, at 27 ("'[o]nce we view the shareholders as simply the residual claimants . . . it is far from self-evident that shareholders are necessarily entitled to control the firm,' i.e., to have managers' and directors' fiduciary duties flow exclusively to them") (quoting CHOPER ET AL., *supra* note 1, at 29).

[88] *See* EASTERBROOK & FISCHEL, *supra* note 18, at 36 ("Corporate ventures may select their preferred constituencies."); WOLFSON, *supra* note 21, at 40 (noting the residual nature of shareholders' claims but stating that "*[s]hareholders are not owners; they are risk takers*") (emphasis in original).

[89] *See* CHOPER ET AL., *supra* note 1, at 33 ("Uniquely, the residual claimants of the firm are interested in the firm's overall profitability, whereas creditors and managers are essentially fixed claimants who wish only to see their claims repaid . . . ."); ROBERT C. CLARK, CORPORATE LAW 389–90 (1986) (voting power should go to residual claimants, "who have the best incentive to use the power"); EASTERBROOK & FISCHEL, *supra* note 18, at 68 ("As the residual claimants, shareholders have the appropriate incentives . . . to make discretionary decisions.").

claims.[90] The requirement to serve the shareholders, then, is arguably the best and closest proxy for a requirement to serve the interests of the enterprise as a whole. Indeed, it can be asserted, their interests are so congruent that there is little meaning in speaking of the difference between serving the shareholders and serving the enterprise. To serve one is to serve the other. This reasoning also provides the basic rationale for giving the shareholders the power to install or replace directors. No one else, it could be said, has the proper incentives to make decisions on behalf of the entire enterprise. As shareholders look after their personal interest they also inherently look after the interests of the firm. A corollary to these propositions is that, if the directors are required to look after the interests of non-residual claimants or if anyone else is allowed to have a say in corporate governance, the firm will lose out, because the interests of other claimants will diverge from those of the firm.[91]

B. *The Residual Nature of Workers' Claims*

For purposes of this Article, the most fundamental critique of the residual claim justification for shareholder dominance rests on the key point that workers, too, have claims against the firm that are residual in nature.[92] To begin, workers' claims against the corporation are not,

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[90] *See* EASTERBROOK & FISCHEL, *supra* note 18, at 36.

[91] *See id.* at 69.

[92] There are other weaknesses as well. One of its flaws is that the argument depends on the notion that all shareholders want the same things for the firm. Easterbrook and Fischel argue that "the shareholders of a given firm at a given time are a reasonably homogeneous group with respect to their desires for the firm." EASTERBROOK & FISCHEL, *supra* note 18, at 70; *see also* Bainbridge, *supra* note 18, at 81 (noting that shareholders are "generally united by a desire to maximize share value"). To be sure, shareholders all want to make money. Beyond that broad generalization, however, there is often much less agreement among shareholders than is assumed. Some investors plan to hold their shares for the long term and will be more interested in long-term returns; others will be looking for quick profits. Some shareholders will be more risk averse than others. Some shareholders—such as union pension funds or socially responsible mutual funds—tend to be more concerned about the interests of non-shareholder constituencies and thus will be more willing to forgo some return to take account of those interests. Some shareholders will be pro-management, perhaps because they are managers themselves, and others will be extremely skeptical of management prerogatives. The putative homogeneity of shareholder preferences may evaporate in any number of concrete situations.

To the extent that there is indeed agreement among shareholders, that very agreement actually may include the assumption that a company should not make decisions solely on the basis of what maximizes returns to shareholders. In research performed by Larry Soderquist and Robert Vecchio, shareholders of large, publicly traded corporations were asked whether they agreed with the following statement: "If corporate profits could be increased by moving a plant, the corporate managers of a large, publicly held corporation should weigh the effect the move would have on its employees, customers, suppliers and people in the community it presently is in before deciding to move." Soderquist & Vecchio, *supra* note 19, at 841. Almost 90% (88.5%) of the shareholders agreed with that statement, 41.3% strongly so. *See id.* Shareholders were also

in any meaningful sense, fixed.[93] This is clearly true for high-level employees whose compensation is tied closely to the fortunes of the firm, through profit sharing or stock options. But, it also applies to employees who work either for a set salary or for an hourly wage. Such workers have both implicit and explicit claims against the enterprise that are more valuable when the company does well and that are worth less (or nothing) when the company does poorly. Unfixed explicit claims against the company include pension or other retirement benefits, which can constitute a significant percentage of a worker's net worth and can lose much of their value if the company fails.[94] Unfixed implicit claims include understandings about job security, the development of firm-specific human capital, the safety of working conditions, promotions policies and expectations, and the like. Much scholarly work has been done to illuminate such implicit understandings between employees and their employers.[95] There is no doubt that many, if not most, workers believe that they do better when their employer does well, and that they do worse when their employer does less well. Put another way, when a company's management makes good decisions for the enterprise as a whole, workers' fortunes improve even if their wages or salaries remain the same. When a company's manage-

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asked to respond to the claim that: "When making corporate decisions, corporate managers of large, publicly held corporations should consider the interests of shareholders, bondholders, customers, employees, and perhaps others." *Id.* Six percent agreed "somewhat," and almost 16% agreed "moderately." *See id.* Over 75% of shareholders "*strongly agree[d]*" with this statement, making it clear that shareholders do not expect their interests to be considered to the exclusion of those of all other stakeholders. *See id.* (emphasis added). This would seem to falsify Stephen Bainbridge's claim that investors "are generally united by a desire to maximize share value." Bainbridge, *supra* note 18, at 81.

[93] *Cf.* EASTERBROOK & FISCHEL, *supra* note 18, at 11 (noting that employees and other non-shareholder stakeholders have "relatively" fixed claims against the enterprise).

[94] *See, e.g.*, Varity Corp. v. Howe, 116 S. Ct. 1065 (1996). In *Varity*, the defendant company created a separately-incorporated subsidiary in which they could place a number of the parent company's outstanding debts and commitments. The plan was to allow the subsidiary to fail and go into bankruptcy, eliminating the obligations. Among the obligations the parent company sought to eliminate were those arising from the parent company's benefit plan's promises to pay certain medical and other non-pension benefits to employees. The parent enticed about 1500 employees to move to the new subsidiary with various representations that their benefits would remain secure if they voluntarily transferred to the subsidiary. These representations were lies, as the parent company knew that the subsidiary was insolvent from the day of its creation. The subsidiary indeed collapsed after two years, and the employees lost their non-pension benefits. *See id.* at 1068–69. The Court held that the employer had breached the fiduciary duty it owed to its employees under ERISA, 29 U.S.C. §§ 1001–1461 (1994). *See Varity*, 116 S. Ct. at 1074.

[95] *See, e.g.*, O'Connor, *Economic Justice*, *supra* note 2, at 219–24; O'Connor, *Nexus of Contracts*, *supra* note 2, at 1203–22; O'Connor, *supra* note 16, at 905–11; Van Wezel Stone, *supra* note 16, at 48–53.

ment makes poor decisions for the enterprise, workers' fortunes decline even if their wages or salaries are unchanged.[96]

Some of the confusion surrounding which of the stakeholders are residual claimants results from the commonplace juxtaposition of the terms "residual" claimants and "fixed" claimants.[97] This is a false comparison, because not all non-residual (prior) claims are fixed. What is pivotal for corporate doctrine, moreover, is not whether a claim is prior or residual, but whether the claim is variable and correlates positively with the fortunes of the firm. The question of whether shareholders should be dominant does not really turn on where they stand in priority when the firm is to be liquidated. In the day-to-day decision-making of most companies, the probability of liquidation in the short-to-medium term is a quite low.[98] What is much more likely, and much more important, is that the company "will continue to operate, generating gains and losses to different claimants . . . ."[99] Workers' claims against the company, for example, need not come last in the unlikely event of liquidation in order to increase in value when the company's fortunes improve and decline in value when the company does poorly. The significant correlation between the gains and losses to non-shareholder stakeholders and the overall health of the enterprise greatly weakens the claim that the best proxy for the health of the firm is the return to the shareholders.

Bernard Black underscores this very point in a forthcoming article.[100] He defines "residual interest" in a firm "to involve any situation in which the expected value of a contracting party's future dealings with the firm increases as the firm's value increases, and decreases as the firm's value decreases."[101] With this definition, Black argues that "the contractarian premise that only shareholders are residual claimants is factually false."[102] As a class, employees clearly "gain when the

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[96] *See* Macey, *supra* note 18, at 29–31 (illustrating how an exclusive focus on shareholders' interests can result in wealth transfers from non-shareholders to shareholders, while also decreasing the overall value of the firm).

[97] *See, e.g.*, CHOPER ET AL., *supra* note 1, at 33 ("Uniquely, the residual claimants of the firm are interested in the firm's overall profitability, whereas creditors and managers are essentially fixed claimants who wish only to see their claims repaid . . . ."); EASTERBROOK & FISCHEL, *supra* note 18, at 68 (comparing shareholders' "residual" claims with the "fixed" claims of others); Bainbridge, *supra* note 18, at 81 ("[S]hareholders are the only corporate constituent with a residual, unfixed, ex post claim on corporate assets and earnings. In contrast, the employees' claim is fixed ex ante through agreed-upon compensation schedules.").

[98] *See* Bernard Black, Corporate Law and Residual Claimants 19 (draft Dec. 1997).

[99] *Id.*

[100] *See id.*

[101] *Id.* at 4.

[102] *Id.* Robert Clark appears to agree. *See* Clark, *supra* note 17, at 57 (noting that large publicly held corporations have "numerous residual claimants").

firm prospers, and lose when it suffers."[103] Indeed, the employees' "aggregate gains or losses are often of the same order of magnitude as gains or losses to common shareholders."[104]

In any event, if by residual claim one means the total net positive wealth of the corporation, it is emphatically not true that "[o]nly shareholders have an economic incentive to care about the size of the residual claim."[105] Employees, too, have incentives to care. Similarly, it is not true that "shareholders are *unique* because they hold variable claims to a firm's income stream."[106] Employees, too, have variable claims.

The interests of employees actually may be the best proxy for the interests of the firm. Consider risk aversion. If we are to believe the assumptions of the contractarians, shareholders invest in a number of different companies and thus have diversified their portfolios.[107] They are therefore risk neutral (and perhaps even risk prone)[108] with respect to the decisions of any specific company. Diversified shareholders prefer that the management of any particular company they invest in makes decisions that maximize the expected value of the results, even if the results also are highly variable.[109] That is, shareholders will tend to prefer risky decisions that may provide high payoffs but risk bankruptcy over decisions that provide lower returns but have less risk of pushing the firm into liquidation.[110] Indeed, shareholders are indifferent as to the liquidation risk of any particular company they invest in

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[103] Black, *supra* note 98, at 4, 18–19.

[104] *Id.* at 4. Black goes on to consider why, as a positive matter, employees and other non-shareholder residual claimants do not typically receive voting rights to protect their residual claims. *See id.* at 32 (noting positive nature of the article). Black's article suggests seven possible explanations for why employees usually do not receive formal control rights "even though they have large residual interests": limited transferability of the employees' interests; heterogeneity within the class of employees; problems with giving the same control rights to different classes; costs of multiple veto rights; delegated monitoring (the notion that most of the time, the shareholders will act in ways that are congruent with employees' interests); firm complexity; and the existence of other informal control rights for employees. *See id.* My concern is more directly to analyze the *normative* claim that fiduciary duties and voting rights should flow to shareholders because of the residual nature of their claims.

[105] Bainbridge, *supra* note 18, at 81.

[106] Macey, *supra* note 20, at 180.

[107] *See* Easterbrook & Fischel, *supra* note 18, at 29 (discussing how diversification makes investors risk-neutral).

[108] *See* Macey, *supra* note 20, at 181 ("Shareholders have a powerful incentive to induce their firms to engage in activities that fixed claimants would consider excessively risky.").

[109] *See* Easterbrook & Fischel, *supra* note 18, at 98 ("A decision is good to the extent it has a high *expected* value, although it may also have a high variance.") (emphasis in original).

[110] *See* Lynne L. Dallas, *Working Toward a New Paradigm*, *in* Progressive Corporate Law, *supra* note 2, at 35, 42, 47 & n.56 (describing concrete ways in which a pursuit of profit maximization may be inconsistent with a company's survival); *see also* Macey, *supra* note 20, at 181 n.27 (quoting Klein & Coffee's assertion that "from any starting point, holding the total

as long as their portfolio, as a whole, maximizes their expected returns. As Easterbrook and Fischel state, "the investor wants to maximize the value of his holdings, not the value of a given stock."[111]

Workers, on the other hand, are not diversified in their labor investment—they typically work for one employer at a time and may have invested much time and effort to develop firm-specific human capital.[112] They are not risk neutral; as to their employment, they are risk averse. Rather than being indifferent as to the liquidation risk of the company for which they work, they care deeply about their firm's financial health because they face harsh consequences from unemployment if their firm suffers.[113] If their company goes bankrupt, workers typically lose a great deal—their jobs, the value of any firm-specific skills and sometimes a portion of retirement or pension benefits. Workers thus prefer that the management of a company they work for not make decisions with a high variance, even when such decisions have a high expected return. Workers instead prefer decisions that value stability, even with a lower expected total return.

The workers' interests arguably function as a better placeholder, then, for the best interests of the firm. Because shareholders are relatively indifferent as to the possibility of any single firm failing, managers who make decisions according to what is good for the shareholders will bring about the failure of their companies more often than managers who make decisions based on what is good for a broader mix of stakeholders. If the question is what is better for the firm, it is not so clear that shareholders' desires should dominate, at least if we define "what is better for the firm" to include survival.

The core issue, of course, is whether firms themselves should be risk averse as to their own demise. If so, then the claim that shareholders' interests are the proper proxy for the interests of the company is weakened significantly. It is perhaps enough, at this juncture, to note that this issue is not one that has been discussed extensively in the literature. It is simply taken for granted that, because the interests of the shareholders should dominate, firms should be risk neutral. But this question has not been considered from the other end of the crucial nexus. If we are trying to decide whether shareholders should be the only stakeholder considered by management in making deci-

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market value of the firm and of all securities constant, a decision that shifts investments in such a way as to increase . . . risk will result in an increase in the value of the common [stock] and a decrease in the value of the bonds.").

[111] EASTERBROOK & FISCHEL, *supra* note 18, at 28.

[112] *See supra* notes 81, 83.

[113] *See* O'Connor, *supra* note 16, at 908 n.26.

sions and whether shareholders should be the only ones with voting rights, we need to decide whether firms should be risk averse as to their own liquidations.

The question as to whether firms should be risk averse—that is, should act as if survival is a value to be pursued—depends on whether such risk aversion makes society as a whole better off.[114] There is little reason to believe that society as a whole is risk neutral with regard to corporate decisions. Society benefits from corporate growth, of course, but it is also concerned with stability and the avoidance of harm. It would be eminently reasonable for society to decide to forgo the possibility of very high corporate profits in order to avoid the disproportionate harm workers (or communities, or creditors) would suffer if risky business decisions do not pay off. This is especially true if a subset of society—those who own shares[115]—reap a disproportionate share of the gains if the risky decision does pay off. Said another way, it is fairly clear that society as a whole (or, for that matter, any of us as individuals, in our daily lives) is not an absolute profit maximizer.[116] There are other economic and noneconomic "goods" we value. It would be odd, then, to assume without question that a major subset of our law—the area that regulates the internal workings of some of the most powerful institutions in our culture—should be constructed to maximize profit at all costs.[117]

In any event, it is important to note that once the difference in risk aversion is considered, the argument for shareholder dominance depends on the claim that workers and other stakeholders care *too much* about the fortunes of the firm. A proponent of the shareholder-centered view of corporate law would have to make the ironic argument that it is better for society as a whole for the decisionmaking of each individual firm to be dominated by stakeholders who care little

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[114] *See* Greenfield, *supra* note 31, at 21–25 (arguing that corporate law should be evaluated not on the basis of rights-based discourse but on the basis of which set of doctrines makes society as a whole better off).

[115] The vast majority of total stock assets are owned by the country's richest citizens. While the poorest 90% of those in the United States own 11% of the stock, the richest 10% own 89% (and the richest 0.5% own 31%). *See Does America Still Work?, supra* note 22, at 44.

[116] *See* Greenfield & Nilsson, *supra* note 6 (arguing that traditional corporate law is based on the irrational utilitarian fixation on the maximization of utility, and that there are other values that corporations should, and do, pursue).

[117] Easterbrook and Fischel admit that if people are risk-averse "they might want a rule maximizing the lower bound of returns rather than maximizing the expected return." EASTERBROOK & FISCHEL, *supra* note 18, at 30. They argue that the law should not reflect a preference for risk aversion because "people who do not like risk can look after themselves at low cost." *Id.* While this assertion may be true for capital investors, it is certainly not true for workers, who cannot easily diversify away their exposure to firm-specific risk.

about the fortunes of each firm. On its own terms, this is hardly a straightforward proposition. And it is surely not what shareholder proponents typically say. As described above, the usual argument is that shareholders are the only ones who have incentives to care about the success of the firm. But that is certainly not the case. Workers, too, have incentives to care. And workers who depend on their company for their livelihood are bound to care more about the success and survival of their individual firm than do shareholders who own hundreds of stocks in diversified portfolios.[118]

IV. Contracting Problems

A. *The Relational Nature of the "Contract" Between Shareholders and Management*

The dominant contemporary narrative of corporate law describes the corporation as a nexus of contracts among managers, shareholders, workers, bondholders, other creditors, customers, the community and assorted others.[119] It is the marketplace writ small.[120] As David Millon recently put it, "[t]he corporation is thus [seen as] nothing more than an arena in which suppliers of capital, labor, services, materials and other necessary contributions come together to pursue their own interests through bargain and exchange."[121] These various parties negotiate with one another to create the entity called a corporation and to determine the precise terms of the legal relationships that constitute it.[122] As a normative matter, contractarians argue that the law should

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[118] *See* Richard A. Posner, Economic Analysis of Law 410 (4th ed. 1992). Posner states that:

> The typical shareholder . . . is not knowledgeable about the business of the firm, does not derive an important part of his livelihood from it, and neither expects nor has an incentive to participate in its management. He is a passive investor and, because of the liquidity of his interest, has only a casual and often transitory relationship with the firm.

Id.; *see also* Fischel, *supra* note 55, at 1276 ("The investor who holds securities in multiple firms is unlikely to have the interest or expertise to participate in running any particular firm.").

[119] *See, e.g.*, Easterbrook & Fischel, *supra* note 18, at 12 ("we often speak of the corporation as a 'nexus of contracts'"); Alchian & Demsetz, *supra* note 15, at 793 ("The firm serves as a highly specialized surrogate market."); Fischel, *supra* note 55, at 1273 ("The corporation . . . is nothing more than a legal fiction that serves as a nexus for a mass of contracts."); Jensen & Meckling, *supra* note 15, at 310 ("Contractual relations are the essence of the firm . . . ."); Macey, *supra* note 20, at 179 ("[A] corporation is simply a net of . . . contractual relationships . . . ."); *see also* Millon, *supra* note 47, at 229–31 (describing theory).

[120] *See* William T. Allen, *Contracts and Communities in Corporation Law*, 50 Wash. & Lee L. Rev. 1395, 1400 (1993).

[121] David Millon, *Personifying the Corporate Body*, *in* 2 Graven Images 116, 123 (1995).

[122] *See* Macey, *supra* note 20, at 179.

recognize the "benefits of private ordering" and thus should "respect the legal arrangements accepted by those within the firm."[123]

Significantly, the legislative and judicial processes are seen as a part of the "contract," at least when it comes to the portion of those processes that create the fiduciary duties of corporate law. As Jonathan Macey asserts, "[w]ithin every successful enterprise, a complex bargaining process allows rights to be 'sold' to those who value them the most. The corporation's charter, bylaws, and, to some extent, the laws of the situs in which the corporation chooses to incorporate, reflect the precise outcome of this process."[124] The corporate law of a particular jurisdiction is seen as a part of the corporate "contract" in that it establishes a set of "off-the-rack" legal rules that mimic what investors and their agents would typically contract to do. If the law is inefficient, it is assumed that the various parties will choose to opt out of the default provisions through explicit contractual terms or will locate their firms (the nexus of their contracts) in some other, more efficient venue.[125]

But why does corporate law typically impose fiduciary duties as a part of this "off-the-rack" contract between managers and shareholders, when fiduciary duties are uncommon in most contracts?[126] According to contractarians, the answer lies in the long-term, "relational" nature of the contract between shareholders and managers.[127] Shareholders hold residual claims, and it is difficult to foresee and resolve ahead of time all the potential contingencies that might affect those claims.[128] "The only promise that makes sense in such an open-ended relation," according to contractarians, "is to work hard and honestly."[129] To enforce such a vague promise, then, the shareholders receive the right to vote and the protection of fiduciary principles.

This reasoning may describe why fiduciary duties are a part of the understanding between shareholders and managers, but it does not, of course, explain why their duties appear as a part of corporate *law*. If they are so crucial to the shareholder/manager relationship, why do they have to be imposed by the state rather than simply arising as a product of explicit contracting between parties? The contractarian answer to this question is that these duties would indeed be a product of explicit contract if the parties "could have bargained . . . at no

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[123] *Id.*

[124] *Id.* at 179–80.

[125] *See* Millon, *supra* note 47, at 230–31.

[126] *See* EASTERBROOK & FISCHEL, *supra* note 18, at 90.

[127] *See id.*

[128] *See* Fischel, *supra* note 55, at 1264.

[129] EASTERBROOK & FISCHEL, *supra* note 18, at 91.

cost."[130] As Fischel asserts: "[T]he reason for having a fiduciary principle . . . is the high cost of specifying things by (express) contract."[131] These transaction costs are even higher after the company has raised equity capital, because "investors have no practical way of revising the articles on their own to overcome intervening legal surprises."[132] In this view, then, the law finds it necessary (i.e., efficient) to impose a set of fiduciary duties on managers because that is how most firms would be organized explicitly but for obstacles to actual negotiation. As Fischel asserts, "[f]iduciary duties serve . . . as a standard form contractual term in every agency [corporate] contract."[133] In the view of contractarians, shareholders are the exclusive beneficiaries of the managers' fiduciary duties because "shareholders face more daunting contracting problems than other constituencies."[134]

B. *Workers' Contracts*

Workers and other stakeholders, according to contractarians, do not need fiduciary duties in their contracts because their contracts can be specific enough to make the imposition of fiduciary duties inefficient.[135] "If contracts can be written in enough detail," say Easterbrook and Fischel, "there is no need for 'fiduciary' duties as well."[136] According to contractarians, there is nothing inherently different between workers and capital investors: "notice that a contractual approach does not draw a sharp line between employees and contributors of capital."[137] The difference is just that in the contractarian world view, workers can protect themselves through explicit contracts, and capital investors cannot.[138] Workers, because their rights can be specified, "must look to their contractual rights rather than invoke fiduciary claims."[139] And if employees bargain for a certain contract with only limited contractual protection from, for example, shocks in the labor market, "they ought not grumble if they are held to their bargains when business goes bad. Each investor must live with the structure of risks built into the firm . . . . [I]t is all a matter of enforcing the contracts. And for any employee . . . that means the explicit negotiated

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130 *Id.* at 92.
131 *Id.* at 93.
132 *Id.*
133 Fischel, *supra* note 55, at 1264.
134 Macey, *supra* note 18, at 36.
135 *See* EASTERBROOK & FISCHEL, *supra* note 18, at 90.
136 *Id.*
137 *Id.* at 37.
138 *See* Macey, *supra* note 18, at 36; Macey, *supra* note 20, at 197.
139 EASTERBROOK & FISCHEL, *supra* note 18, at 91.

contract."[140] Indeed, the absence of protections within the labor contract does not mean, according to contractarians, that workers are unable to bargain for those protections. "Rather, the absence of contractual protection . . . may simply reflect the fact that such [non-shareholder] constituencies are unwilling to pay for such protection in the form of lower wages . . . ."[141]

To take a specific example, Jonathan Macey admits that the development of firm-specific human capital exposes workers to the possibility of exploitation through forced renegotiation of their contracts.[142] The employees can solve this problem, says Macey, "by forming a union to ensure that they will not be treated opportunistically."[143] In other words, if the contract does not protect them, the workers should be able to depend on collective action to protect their interests. The law, or at least corporate law, does not need to be the source of protection.[144]

To be sure, these contractarian assumptions about the power of workers to protect themselves through contract and market forces are open to challenge. It would hardly seem obvious to most people, especially to most workers, that employees have greater ability to protect themselves from managerial exploitation than do capital investors. This assumption seems unconnected to the reality of economic relations in the late twentieth century, and it seems odd to urge that rank-and-file workers should and can rely on their own market power while the already considerable market influence of venture capitalists, investment bankers, mutual funds and other institutional investors needs to be bolstered and protected by fiduciary duties imposed by law.

Yet, contractarians would almost certainly admit, if pressed, that their views do not depend on an empirical claim that workers and other non-shareholder stakeholders could *actually* protect themselves through contract or collective action. Rather, contractarians would argue that any attempt to help workers through law and regulation would result in a worse outcome than if they relied on their (even

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[140] *Id.* at 37.

[141] *Id.* at 36.

[142] *See* Macey, *supra* note 20, at 191–92; *see also supra* notes 83, 84 and accompanying text (discussing this problem in the context of the discussion of agency costs).

[143] Macey, *supra* note 20, at 192.

[144] Though it also appears that Macey would argue that other, noncorporate, law and regulation should not be used to assist workers either. *See id.* at 174–75 (listing reasons why "the private contracting process . . . generates outcomes superior to the outcomes generated by government regulation"); *id.* at 195–97 (criticizing the Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§ 2101–09 (1994), which offers some employees of some companies advance notification of some plant closings and layoffs).

presumably) weak market power.[145] This outcome comes about because employers would, in effect, force workers to pay for any benefit they received through the law.

This argument that workers will be hurt by laws that are intended to help them is subject to serious objections.[146] Yet, even setting such objections aside for the moment, it is useful to focus on the contractarian claim that workers should be forced to depend on the rights that they are able to gain through contract bargaining, while capital investors are properly assisted by law in their bargaining with management. This claim rests on certain assumptions about the contracting process that occurs (explicitly or implicitly) between shareholders and management, and these assumptions then are used as the basis for legal intervention. If these same assumptions hold as well for the contracting process between workers and management, however, then the argument for shareholder dominance is weakened.

Consider first the contractarian claim that it is very difficult for shareholders and managers to anticipate the various contingencies that might affect shareholders' claims.[147] This claim would appear to hold for workers as well. Once one recognizes that workers' claims on their employers are not fixed, as illustrated in Part III above, it becomes clear that the ability to define rights and obligations specifically for the duration of an employment relationship becomes very difficult, if not impossible. If shareholders—who are assumed to own diversified portfolios and who buy and sell stock in a liquid, efficient market—have a "contract" with management that is considered "relational,"[148] then this categorization must be doubly true for workers, who typically work for one company at a time and who often stay in their jobs for many years.[149] A vast array of factors can affect the relationship between workers and management. To the extent that it is difficult to place in writing all the important aspects of the shareholder/manager relationship, it is surely at least equally difficult to reduce to writing all the important considerations that influence the employee/employer relationship.

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[145] *See* Macey, *supra* note 18, at 37 (arguing that changing the law to add a fiduciary duty to the employer/employee relationship will harm workers).

[146] *See* O'Connor, *Nexus of Contracts*, *supra* note 2, at 1244–45; O'Connor, *supra* note 16, at 941–42; Singer, *supra* note 2, at 720–23.

[147] *See, e.g.*, Fischel, *supra* note 55, at 1264.

[148] *See* EASTERBROOK & FISCHEL, *supra* note 18, at 90.

[149] *See* O'Connor, *supra* note 16, at 907 (noting that one-fourth of the total workforce and over half of the male workforce remain at the same company for at least 20 years) (citing Robert E. Hall, *The Importance of Lifetime Jobs in the U.S. Economy*, 72 AM. ECON. REV. 716, 724 (1982)).

Marleen O'Connor has offered an argument to support the claim that the implicit and explicit contracts between management and workers are long-term, relational and impossible to reduce to even a detailed writing. First, she argues that participatory management programs are increasingly becoming the norm in United States workplaces.[150] The participatory style of work management in some ways puts workers at greater risk than they were subject to under the traditional regime of management, which sought to maximize productivity by developing a high degree of specialization among workers.[151] Participatory programs ask workers to develop more firm-specific skills, which, as discussed above, make these workers more vulnerable to employer opportunism.[152] Workers may demand safeguards against this opportunism but, as O'Connor points out, the workers and management will be unable to ensure these safeguards through collective bargaining.[153] Collective efforts to improve productivity "simply cannot be written into detailed, contractual specifications."[154] Moreover, decisions on strategic matters that affect the entire company—matters such as production processes and investment rates—"do not lend themselves to the collective bargaining process. The reason is that neither management nor labor has perfect foresight; thus, substantial problems of information and enforcement that arise as a result of bounded rationality and opportunistic conduct impede efforts to protect employees against every contingency in explicit contracts."[155] Contracts, therefore, if we mean contracts negotiated through collective bargaining, are simply insufficient to meet the needs of contemporary labor relations.

O'Connor also posits that the contractual relationship between employers and employees is doomed to vagueness because neither side "can credibly commit . . . [through] traditional explicit and implicit contractual safeguards" to a bargain in which the workers provide the highest level of effort in return for the best working conditions.[156] Workers face difficulty in giving credible commitments to provide their best efforts, for example, and employers face barriers in offering credible commitments for employment security. Contracts for job security, according to O'Connor, are costly to draft and enforce.[157] Without such

[150] *See id.* at 911.

[151] *See id.*

[152] *See id.* at 923; *supra* notes 83, 84, 142 and accompanying text.

[153] *See* O'Connor, *supra* note 16, at 916.

[154] *Id.*

[155] *Id.*

[156] *Id.* at 918.

[157] *See id.* at 919.

contracts, workers cannot trust management and cannot invest in firm-specific skills without leaving themselves vulnerable to employer opportunism. Knowing that employees are not providing the highest level of effort, employers will lack incentives to provide job security.

Thus workers and managers often find themselves in a "prisoners' dilemma." Both parties desire that the workers provide the highest level of effort in return for the best working conditions, but neither party can "credibly commit to achieve this outcome by using traditional explicit and implicit contractual safeguards."[158] O'Connor points to the work of economist Harvey Leibenstein, who proposes that workers and employers can partially ameliorate such prisoners' dilemmas by establishing "effort conventions."[159] These "conventions" are essentially informal and implicit understandings about the appropriate level of effort and working conditions.

For present purposes, O'Connor's key insight is that the relationship between management and workers is at least as relational and irreducible to writing as the relationship between management and shareholders. Workers and management thus face significant barriers to contracting, in that they face huge transaction costs in reducing to writing all the implicit understandings necessary to reach the outcome best for both parties. If the presence of fiduciary duties are necessary in the shareholder-management context to serve as gap-filling and contract-enforcing devices, they certainly could serve an analogous purpose in the employment relation.

Indeed, there are reasons to believe that fiduciary duties are more important in the worker/management relationship than in the shareholder/management relationship. First, and perhaps most centrally, fiduciary duties are primarily about relationships.[160] As noted above, the interaction between workers and the firm is much more relational than that between the shareholder and the firm.[161] Most shareholders of public corporations have little in the way of a genuine relationship

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[158] O'Connor, *supra* note 16, at 918.

[159] *See id.* at 920 (citing HENRY LEIBENSTEIN, INSIDE THE FIRM: THE INEFFICIENCIES OF HIERARCHY 77–78 (1987)).

[160] *See, e.g.*, Lawrence E. Mitchell, *Trust. Contract. Process.*, *in* PROGRESSIVE CORPORATE LAW, *supra* note 2, at 185, 190 ("Fiduciary relationships are, characteristically, relationships of power and dependency."). *See generally* Scott FitzGibbon, *Fiduciary Relationships Are Not Contracts: A Defense of* Fidelitatis Connexio *Against the Assault by Utilitarianism and Economic Analysis*, 81 MARQ. L. REV. (forthcoming Summer 1998).

[161] O'Connor's work is central here as well. *See generally* O'Connor, *Economic Justice*, *supra* note 2; O'Connor, *Nexus of Contracts*, *supra* note 2. While the focus of this Article is on corporations, this argument from the relational basis of fiduciary duty might conceivably be extended to all employer/employee relationships, even when the employer is not a corporation. I am thankful to James R. Repetti for this point.

with the companies in which they hold stock, other than as arms-length investors.[162] A typical shareholder may have a significant amount of turnover in her portfolio in any given year. Workers, by contrast, have a close connection to the firm that employs them and may hold their jobs for years.

The second reason why fiduciary duties seem more important in the labor relationship is the fact that shareholders already have many other ways to enforce their implicit and explicit agreements with management. As discussed above in Part II, shareholders have available a number of avenues to reduce the agency costs inherent in their relationship with management: an efficient capital market, the market for corporate control, a vigorous market for corporate managers who maximize shareholder welfare. Workers enjoy many fewer market protections from managerial exploitation and shirking.

In addition, shareholders actually have much greater power to engage in genuine negotiation with management, especially at the time a firm is issuing stock (whether in an initial or secondary offering). Though individual shareholders may not have access to the negotiations, the concerns of shareholders are ably represented by venture capitalists, investment bankers, large institutional shareholders and the like. The vast majority of workers, on the other hand, must engage in one-on-one bargaining with the firm, when bargaining occurs at all. Indeed, workers face explicit obstacles to bargaining that investors do not. Even when workers are represented by unions, under the existing framework for collective bargaining, firms have no legal duty to negotiate with unions about economic restructuring, technological innovation and job security.[163] Even more jarring to the contractarian assumptions about the power of workers to bargain is the fact that specific kinds of contracts that unions actually win become null and void after some corporate takeovers.[164] Thus, even when workers

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[162] *See* Soderquist & Vecchio, *supra* note 19, at 836. In their survey, Soderquist and Vecchio asked shareholders whether they agreed with the statement: "Owning stock in a large, publicly held corporation is more like owning a corporate bond than like being a partner in a partnership." *Id.* The survey found that 16.1% of shareholders agreed somewhat with that statement, 20.6% moderately agreed and 21.2% strongly agreed (a total of 57.9% in agreement). *See id.* Shareholders were also asked whether they agreed with the statement that: "Shareholders in large, publicly held corporations should be considered as investors rather than owners." *Id.* Of the shareholders polled, 13.3% agreed somewhat, 25.6% agreed moderately and 20.6% agreed strongly (a total of 59.5% in agreement). *See id.*

[163] *See* First Nat'l Maintenance Corp. v. NLRB, 452 U.S. 666, 681–86 (1981) (no duty to bargain over the decision to terminate business); Otis Elevator Co., 269 N.L.R.B. 891, 893–94 (1984) (no duty to bargain over relocation); *see also* O'Connor, *supra* note 16, at 940; Van Wezel Stone, *supra* note 16, at 56–58.

[164] *See* Van Wezel Stone, *supra* note 16, at 62 ("In the event of a sale of assets, the labor law successorship rules hold that the preexisting collective bargaining agreement does not survive

do in fact enter into contracts, their efforts are sometimes erased. The relative benefit of fiduciary duties, then, would be much greater in the employment relation than in the investor/management relation. Because the relative benefit of a legal protection is an important aspect of determining the appropriateness of a legal norm, the relative balance in this respect is also in favor of workers.

Third, there is greater reason to doubt that the actual contracts resulting from negotiation between workers and management are the result of purely voluntary and consensual interchanges. One of the key assumptions within the contractarian framework (it is an important part of the first chapter of Easterbrook and Fischel's book) is that all the important terms within the shareholder/managerial contract are priced through the efficient capital market. The fact that the terms all have a price associated with them means that contractarians can call the complete contract "consensual" in that all powers the managers retain in corporate governance reduce the price the firm can get for its securities, and any shareholder who buys the security can be said to have agreed completely to the contract. As Easterbrook and Fischel state, "[a]ll the terms in corporate governance are contractual in the sense that they are fully priced in transactions among the interested parties."[165] Terms need not actually be negotiated; "the pricing and testing mechanisms are all that matter."[166] Put another way, "[t]he price [of a company's securities] reflects the effects, good or bad, of corporate law and contracts, just as it reflects the effects of good and bad products."[167]

Moreover, it is crucial to the contractarian argument that there are no perceptual biases in the pricing of the terms of corporate governance.[168] That is, if parties to a contract systematically underestimate certain risks or overestimate the chances of beneficial outcomes, or if parties are unaccustomed to certain problems or risks, the chance of mistake is high. According to the contractarians, these risks of systematic mistakes are low in the capital market because even though individual investors may know little about corporate governance, the

against the new corporate entity. Nor does it survive most mergers.") (citing Howard Johnson Co. v. Detroit Local Joint Exec. Bd., 417 U.S. 249 (1974); NLRB v. Burns Int'l Sec. Serv., Inc., 406 U.S. 272 (1972); John Wiley & Sons v. Livingston, 376 U.S. 543 (1964)). For an argument that successorship rules should be used to protect workers, see Michael C. Harper, *Defining the Economic Relationship Appropriate for Collective Bargaining*, 39 B.C. L. Rev. (Mar. 1998) (Part IV).

[165] Easterbrook & Fischel, *supra* note 18, at 17.

[166] *Id.*

[167] *Id.* at 19.

[168] *See id.* at 22–24.

prices of securities are set by professional investors in a liquid market, and "[t]hese prices protect ignorant investors automatically."[169]

Note, however, that workers are not aided in either respect by "liquid markets with professional investors setting price."[170] The labor market is much less efficient than the securities market, so it is much less likely that every term in the "contract" between firm and worker will be priced correctly. If the prices (i.e., wages plus other compensation) are less likely to reflect the true underlying "value" of the job, then we can less easily assume that the workers' agreement to enter into the contract is truly "consensual," as contractarians use that term. Also, if workers have a relatively difficult time leaving their jobs and finding an adequate substitute, then their decisions to remain in their present positions are less reflective of their genuine preferences than investors' decisions to retain a certain bundle of shares.[171] Moreover, the inefficiency of the market and the relative scarcity of professional price-setters in the labor market makes the likelihood of systematic mistake much greater.[172] To be sure, unions may assist in setting prices in the labor market and may mimic, to some extent, what professional investors and market makers do in the capital market. But unions represent only a small percentage of all workers in the United States. It is unrealistic to assume that unions are as powerful in the labor market as professional investors are in the capital market.[173] Even

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[169] *Id.* at 23–24.

[170] EASTERBROOK & FISCHEL, *supra* note 18, at 25.

[171] *See* Greenfield, *supra* note 14, at 749. The mistake of assuming the free and cost-free movement of workers from one job to another is a common one in the contractarian literature. *See, e.g.*, WOLFSON, *supra* note 21, at 100 ("In the free enterprise corporate system, however, workers are free to move from one corporation to the next in search of a trade off between wages and working conditions that will best satisfy their individual preference.").

[172] Another example of possible perceptual biases involves the barriers individuals erect in their own minds against information that conflicts with their present activity. Consider Robert Ellickson's example of workers' compensation statutes, first adopted in the early twentieth century, which made employers strictly liable for employee injuries suffered on the job. *See* Robert C. Ellickson, *Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics*, 65 CHI.-KENT L. REV. 23, 42–43 (1989). If the labor "contract" worked in Coasian terms, these statutes would not have increased employer safety efforts because employees would have agreed to wage concessions in order to obtain the efficient level of job safety. *See id.* at 42. The evidence, however, is that these statutes did indeed significantly improve worker safety. *See id.* at 42 & n.57. Ellickson posits that one possible explanation for this result is what he calls "cognitive dissonance": "once on a job, an employee might start walling out information about its hazards, and thus come to undervalue the benefits of innovations in safety equipment." *Id.* at 43. I would add that to the extent that workers receive less information from their employers in the first place, both because of the fact that the workers cannot negotiate for information disclosure very easily and because it is not required by law to the same extent as in the capital market, such "cognitive barriers" are more likely.

[173] *See* Greenfield, *supra* note 14, at 781–82. Unions are relatively weak in the United States compared to other industrial nations, and their strength is in a period of historical decline. Fewer

contractarians concede that the marketplace protects capital investors more than any other party to the corporate contract: "[T]he most powerful device for protecting participants in the [corporate] venture—liquid markets with professional investors setting price—applies exclusively to investors, principally equity investors."[174] The contractarians nevertheless believe that shareholders constitute the only parties to the corporate contract who should be the beneficiaries of the directors' fiduciary duties imposed by law. If the justification for fiduciary duties is based on difficulties with contracting, it would seem to make sense for workers to be the beneficiaries of such duties as well.

V. Efficiency

It appears, therefore, that none of the dominant contractarian justifications for shareholder preeminence adequately distinguishes the interests of shareholders from those of workers. Workers, too, bear agency costs of monitoring management; they retain an unfixed, residual interest in their firm; and they are parties to long-term, relational contracts with management in which it is very difficult to reduce all important aspects of the agreement to writing. Contractarians make one additional argument. In a sense, it underlies all the others. Though it represents a fundamental assumption of contractarian analysis, it is often left understated. I am referring to the notion of efficiency, defined as making decisions based on maximizing utilitarian value, measured by willingness to pay. Macey makes the claim explicitly in his discussion of why only shareholders should receive the right to vote for directors: "Shareholders retain the ultimate right to control corporations because they value this right more than do other groups and because it is therefore more efficient for them to retain control."[175] In other words, voting rights are held by shareholders and fiduciary duties flow to shareholders simply because they are willing to pay more for those rights than is any other party to the corporate contract.

This final claim is probably the most important one contractarians make. One way to characterize the other claims for shareholder dominance is that they are not justifications for shareholder supremacy per se, but simply reasons why shareholders are willing to pay more to be

than one out of every five workers in the United States is represented by a union. *See* Van Wezel Stone, *supra* note 3, at 578 (stating that, between 1980 and 1990, union membership declined from almost 25% of the nonagricultural work force to less than 17%); *see also* International Labor Office, World Labor Report 1993, at 34 tbl.3.1 (1993) (showing union density in the United States at 15% in 1989 compared to, for example, 32% in Germany, 39% in the United Kingdom, 45% in Australia and 81% in Sweden).

[174] Easterbrook & Fischel, *supra* note 18, at 25.

[175] Macey, *supra* note 20, at 175.

supreme. The real, core reason for having the law award shareholders sole beneficiary status, according to the contractarians, is that absent all obstacles to contracting, shareholders would simply be willing to pay more for that status, and the law should recognize such preferences.[176] Moreover, contractarians argue, we know that shareholders value these rights more than anyone else because, as a positive matter, that is what one observes within corporate doctrine.[177] If others valued the right to have fiduciary duties run to them more than shareholders, they would simply purchase those rights from the shareholders.[178]

One can contest this contractarian claim on at least two levels. First, even if efficiency ought to be the basis for making public policy judgments, there are reasons to doubt that what one observes in corporate law truly represents the aggregate preferences of all those involved. That is, if transaction costs in fact were zero, and if other market flaws were corrected for, one might observe a corporate regime quite different from the one dominant today. Second, there is a more fundamental critique of the efficiency norm as the basis for public policy. The efficiency norm is rooted in utilitarianism, and there is a powerful argument that public policy should include substantial concern for non-utilitarian values.

Some of the reasons to doubt that the shareholder dominance we observe in contemporary corporate doctrine is in fact efficient were noted in Part IV above. The labor market is much less efficient than the capital market in pricing the terms of the "contract" with the firm. Workers have fewer institutional mechanisms (including affirmative disclosure requirements and fraud protection) to enable them to engage in genuine negotiation with their firms. There is thus less reason to be confident that the "contract" with management is not based at least in part on perceptual biases or mistake. Also, due to the lack of liquidity in the labor market—that is, because of the difficulties a worker faces in moving from one job to another—a worker's observed behavior of staying in a job can less certainly be said to reveal her preference of that job over another.

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[176] *See* EASTERBROOK & FISCHEL, *supra* note 18, at 15 ("The normative thesis of the book is that corporate law should contain the terms people would have negotiated, were the costs of negotiating at arm's length for every contingency sufficiently low.").

[177] *See id.* ("The positive thesis [of this book] is that corporate law almost always conforms to this model.").

[178] This notion is of course based on the Coase theorem, which posits that, absent transaction costs, market participants will bargain around any given regulation so that those who value a right most will end up owning it. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960); *see also* POSNER, *supra* note 118, at 42–48.

In addition, such inefficiencies in the labor market provide significant reason to be concerned that the shareholder/management contract actually externalizes costs of that agreement onto workers. Importantly, even contractarians believe that actual contracts can be trumped if they have adverse effects on third parties.[179] Contractarians argue, however, that the corporate contract does not create any third party effects because all participants in the corporate enterprise are parties to the corporate "contract" and can protect themselves through negotiation.[180] The explicit assumption is that there are no externalities because workers are voluntary participants in the firm and have the power to protect themselves. As Easterbrook and Fischel argue, "[t]he corporation's choice of governance mechanisms does not create substantial third-party effects—that is, does not injure persons who are not voluntary participants in the venture . . . . [E]mployees . . . can participate or go elsewhere."[181]

On a simple level, Easterbrook and Fischel's claim that the choice of governance mechanisms does not hurt workers is facially untrue. A corporate "contract" that requires shareholders' interests to be placed ahead of all others causes workers to be hurt in concrete circumstances, whether plant closings, takeover contests, or wage negotiations. But what Easterbrook and Fischel almost certainly mean to assert is that workers cannot be hurt *ex ante* because they will demand wage or other concessions from the firm to compensate for being subject to the shareholder-dominance rule. If they do not like the concessions the firm offers, they can "go elsewhere." In other words, for the contractarian argument to be persuasive, one must believe that in a firm with a rule of shareholder dominance—that is, a firm in which the directors have a fiduciary duty to maximize shareholder returns even when workers will be harmed—employees will negotiate and will win benefits in return for being subject to the shocks and disruptions such a rule allows or even requires.

It should be reiterated here that because of the inefficiencies and illiquidity in the labor market, workers are much less able to "go elsewhere," and they are much less able to demand and receive wage

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[179] *See* EASTERBROOK & FISCHEL, *supra* note 18, at 23; *see also id.* at 17 ("the pricing and testing mechanisms are all that matter, as long as there are no effects on third parties").

[180] *See id.* at 23. Easterbrook and Fischel argue that "[n]one of these justifications for intervention applies to intra-corporate affairs." *Id.* They also state that "[p]articipation in corporations is uniquely amenable to contracting because even the ignorant have an army of helpers." *Id.* at 24. They further note that "*[e]verything* to do with the relation between the form and the suppliers of labor . . . is contractual." *Id.* at 16 (emphasis in original).

[181] *Id.* at 17.

and other concessions for being subject to the shareholder-dominance rule. The agreement between shareholders and management, then, may indeed include terms that externalize costs onto workers.[182] More concretely, management can agree to owe fiduciary duties to shareholders and to give voting rights to shareholders (in return for an equity contribution of a greater amount or at a lower cost), knowing that some of the costs of this agreement can be shifted to workers. This point does not depend on an assertion about bargaining power per se, nor does it rely on the importance of wealth redistribution to workers.[183] Rather, it depends on an awareness of the differences between the nature of the labor input and the capital input. The very nature of labor makes "pricing and testing mechanisms"[184] much less perfect than those in the capital market. It is very likely, then, that participants in the capital market can and do enter into both explicit and implicit agreements that take advantage of the core inefficiencies in the labor market.

There are other market-based reasons to doubt that the corporate "contract" now in place is the efficient one. There may be a divergence between willingness-to-pay and willingness-to-accept. Workers may be unwilling, given the present bundle of goods and rights they own, to pay in wage concessions for the privileges of voting for directors or having directors include their interests in corporate decision making, even if they would refuse to accept an offered wage increase to give up such rights if they already had them.[185] Moreover, what one observes as the allegedly revealed preferences of workers to work for firms with a shareholder-dominant rule may be a result of preferences that are at least partially endogenous to the present regime. If workers' preferences are determined at least in part by the existing regime, then it is much more difficult to argue persuasively that the regime itself maximizes utility, measured by revealed preferences.[186]

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[182] *See* Mitchell, *supra* note 16, at 605–06 (discussing externalities of corporate decisions).

[183] *See infra* Part V.B.

[184] EASTERBROOK & FISCHEL, *supra* note 18, at 17.

[185] *See* Ellickson, *supra* note 172, at 35–37 (discussing the possibility that people will consider the loss of something they already own valued at $X as worse than the loss of an opportunity to gain something they did not already own valued at $X); O'Connor, *Economic Justice*, *supra* note 2, at 241–42 & n.192.

[186] *See* MARTHA C. NUSSBAUM, LOVE'S KNOWLEDGE 62 (1990) (noting that one must be skeptical of the notion that preferences of severely deprived people should be trusted, since preferences adjust to what one's actual situation makes possible); CASS R. SUNSTEIN, AFTER THE RIGHTS REVOLUTION: RECONCEIVING THE REGULATORY STATE 64–67 (1990) (discussing endogenous preferences).

These market defects are likely to exist within the nexus of contracts known as the corporation. Yet these inefficiencies and defects are not taken by contractarians to be a basis for regulation, much less a justification for replacing the shareholder-dominance rule. One must wonder why market inefficiencies in the capital market are taken to be a justification for shareholder dominance (witness the rationale that fiduciary duties are necessarily imposed by law because shareholders cannot bargain for them on their own) but market inefficiencies in the labor market are assumed away.

Finally, one might criticize the contractarian norm of efficiency from outside of the value system of utilitarianism that forms its basis. Scholars have debated for decades the use of efficiency as a value in public policy, and philosophers have debated utilitarianism for even longer. What may be worth noting in the present context is the fact that the law of corporations is one of the few areas of law where the virtues (no pun intended) of utilitarianism are so taken for granted as to go largely unquestioned. It should suffice to say here that as there are a number of reasons to question the preeminence of efficiency as the touchstone for public policy in other areas of law and regulation, there are similar grounds to question that norm in corporate law. As a society, just as we do as individuals, we make decisions and prioritize public policy choices based on a range of values. Efficiency is almost certainly one of these. But so are incommensurables such as equality, and dignity, and knowledge.[187]

Perhaps, then, we should recognize that even in an efficient market, workers will win relatively few concessions from management and their shareholder bosses because, on balance, most shareholders are affluent and most workers for whom fiduciary duties would matter most are not.[188] And because the ability of parties to bargain is a function of their preexisting entitlements and wealth, we can be certain that the bargained-for, "efficient" outcome is best only if we believe that the preexisting circumstances accord with our societal judgments of what is fair and just.[189] If preexisting circumstances are not consistent with what we aspire to as a society, we might want to use corporate law

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[187] *See* Joseph William Singer, Entitlement 35 (manuscript of December 1997, on file with author) ("Consequentialist analysis is indeterminate unless we choose baselines from which to start our analysis and considerations of justice are essential to choose appropriate baselines.").

[188] While the richest 10% of this nation's citizens owns 89% of the nation's total stock assets, see *Does America Still Work?*, *supra* note 22, at 44, a person's yearly earnings for full-time work at minimum wage is about $10,300. (The poverty level for a family of four is about $15,600). *See Federal Minimum Wage Increases to $5.15 an Hour*, WALL ST. J., Sept. 2, 1997, at A2.

[189] *See* Singer, *Reliance Interest*, *supra* note 2, at 649.

as we sometimes use other branches of our law, to ameliorate systemic imbalances and injustices that characterize our economy. Perhaps we would want to use the law to substitute democratic decisions for market decisions. We could even choose to use the law to protect the weak from the powerful, rather than aiding the powerful against the weak. If these other values matter, as I believe they do, there is no *prima facie* reason why corporate law should not be influenced by these values, just as they influence environmental law, constitutional law and tax law.

Conclusion

This Article has examined leading justifications for shareholder dominance in corporate law, with special attention to whether these justifications also apply to workers. Traditionally, shareholders have been the beneficiaries of fiduciary duties and are the only ones to vote for directors because shareholders are considered the owners of the enterprise. This assertion of ownership turns on other, more sophisticated bases and has fallen away from being the dominant justification. The contemporary narrative of corporate law bases shareholder preeminence on the importance of reducing agency costs, on the residual nature of the shareholders' claim, on the difficulty shareholders face in gaining explicit contractual protection, and on efficiency, i.e., the shareholders' willingness and ability to "pay" more than other stakeholders for supremacy.

These justifications for shareholder preeminence, however, do not adequately distinguish the interests of shareholders from those of workers. Workers, too, bear agency costs of monitoring management to ensure that management fulfills its part of the implicit and explicit understandings that define the relationship. Workers, too, retain an unfixed, residual interest in their firm; their fortunes rise when the company does well, and they are worse off when the company founders. Workers, too, enter into long-term, relational contracts with management in which it is very difficult to reduce all important aspects of the agreement to writing. The fact that workers have much in common with shareholders argues for a closer examination of the affirmative arguments for the creation of fiduciary duties running to workers and for worker participation in company management.

Finally, there are reasons to doubt that what one observes as a positive matter in corporate law is an accurate reflection of the preferences of all the parties to the corporate "contract." Because of inefficiencies in the labor market (many of which are simply assumed away in leading corporate law scholarship), workers have much less ability

than shareholders to exact bargaining concessions from other contracting parties or simply to walk away. These inefficiencies also make it more possible that the shareholder/management "contract" externalizes some of the costs of their agreement onto workers.

Even if these inefficiencies did not exist, there are grounds to question whether efficiency should be the sole policy basis for corporate law doctrine. There is no doubt that, on the whole, shareholders are able to "pay" more than workers for the privilege of preeminence. Efficiency, however, is but one basis for public policy. Other bases for public policy include fairness, justice and concern for human dignity. These ideals generally do not, but could, influence corporate law doctrine as they influence other areas of law. Corporate law would be the better for it.