

Human Capital ERA: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation

Marleen A. O'Connor

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THE HUMAN CAPITAL ERA: RECONCEPTUALIZING CORPORATE LAW TO FACILITATE LABOR-MANAGEMENT COOPERATION

Marleen A. O'Connor †

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INTRODUCTION

As U.S. corporations face intensifying global competition, American labor relations are undergoing a historic transformation.¹ Increasingly, many U.S. managers are seeking a competitive edge by changing their traditionally adversarial relationship with labor. Instead, firms are attempting to reshape their corporate cultures to foster the high-trust work relations necessary to support changing methods of work organization. Firms are responding to international market demands by moving away from hierarchical production processes that involve narrow job assignments and close supervision. Firms have implemented participatory work programs that encourage workers to engage in problem-solving and dialogue concerning production inefficiencies. Industrial relations experts maintain that these innovative shopfloor practices usually improve employee attitudes in the short-run and thus lead to temporary increases in productivity. Preserving a cooperative workplace atmosphere, however, has proven to be a more difficult task.²

At the same time that firms struggle to promote worker commitment and morale on the shopfloor, market pressures frequently require directors to revise strategies involving production processes and plant locations in ways that adversely impact the employees' welfare by threatening job security. Because workers have no right to influence these decisions through the traditional collective bargaining process, they have no guarantee that directors will weigh their concerns when formulating strategic corporate policies. Thus, the existing paradigm of the employees' role in the corporate structure reveals an internal contradiction: cooperative innovations on the shopfloor have not been supplemented by corresponding policies at the higher levels of corporate planning involving collective bargaining and board decisionmaking.

This inconsistency raises the issue whether the traditional system of corporate governance can accommodate the challenges of international competition. Most of the corporate scholars addressing this question concentrate upon reforming the federal securities laws to remove legal impediments that prevent institutional shareholders from exercising their power.³ This seems to be a step in the

¹ For further discussion of how firms are changing production processes to meet changing market demands, see PETER B. DOERINGER, *TURBULENCE IN THE AMERICAN WORKPLACE* (1991); THOMAS A. KOCHAN ET AL., *THE TRANSFORMATION OF AMERICAN INDUSTRIAL RELATIONS* (1986); MICHAEL J. PIORE & CHARLES F. SABEL, *THE SECOND INDUSTRIAL DIVIDE: POSSIBILITIES FOR PROSPERITY* (1984); ROBERT B. REICH, *THE NEXT AMERICAN FRONTIER* (1983).

² KOCHAN ET AL., *supra* note 1, at 110.

³ For a discussion of the role of institutional shareholders, see ROBERT MONKS & NELL MINOW, *POWER AND RESPONSIBILITY* (1991); Bernard S. Black, *Shareholder Passivity*

right direction. Yet, this focus upon financial capital is too narrow because it ignores one of the most significant factors of competitiveness in global markets—the role of human capital. Corporate scholars must join labor scholars in rethinking traditional solutions to corporate governance in order to accommodate the changing role of employees in the corporate structure. Many European countries have a long history of recognizing the employees' voice in corporate governance. The time has come to reshape conventional corporate law discourse in the United States to encompass employees as members of the firm.

In this Article, I focus on expanding the existing fiduciary duties of directors to encompass obligations to employees. This raises profound political questions about reforming corporate law to regulate the employment relationship. Entering this debate requires choices about the types of analytical tools that will promote dialogue concerning the fiduciary duties of directors. When Professors Berle and Dodd examined this topic over fifty years ago,⁴ the law and economics movement did not exist. Although efficiency analysis cannot provide definitive answers, economic models can enlighten policy discussion when used with a normative vision about the kinds of relationships the law should encourage. This Article maintains that legal reform requiring labor participation in corporate governance is necessary not only to achieve social goals concerning industrial democracy but also to promote efficient corporate behavior in a changing world economy.⁵

Reexamined, 89 MICH. L. REV. 520 (1990); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117 (1988). Corporate scholars are beginning to look at corporate governance as a means to foster efficient production. Ronald Gilson & Mark Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L. J. 871 (1993).

⁴ For the exchange between Professors Berle and Dodd, see Adolf A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); E. Merrick Dodd, Jr., *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?*, 2 U. CHI. L. REV. 194 (1935); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

⁵ Academics and practitioners should strive to use new perspectives to reconceptualize the corporation that protects the noncontractual expectations of employees. These perspectives include critical legal studies, feminist jurisprudence, and critical race theory. In my view, given the current economic climate, questions of efficiency must be considered in discussing the employees' role in the firm. See, e.g., Karl E. Klare, *Workplace Democracy & Market Reconstruction: An Agenda for Legal Reform*, 38 CATH. U. L. REV. 1, 7 (1988) ("Efficiency is simply too important a matter to be left to management.") [hereinafter Klare, *Agenda*]; see also Karl E. Klare, *The Labor Management Cooperation Debate: A Workplace Democracy Perspective*, 23 HARV. C.R.-CL. L. REV. 39 (1988) (arguing that concerns about equity and self-realization cannot eliminate attention to efficiency) [hereinafter Klare, *Debate*].

The stakeholder debate has prompted corporate scholars to search for different perspectives from which to analyze corporate law. See, e.g., John C. Coffee, Jr., *Unstable*

As a first step, Part I seeks to reinforce this position at what has been its weakest point—vulnerability to prevailing economic theories. Part I uses the transaction cost model of the firm to examine innovative shopfloor practices. This analysis reveals that participatory work programs require workers to invest in firm-specific skills in an environment of increasing employment insecurity. Given these additional transactional hazards, the transaction cost model demonstrates that the traditional collective bargaining solution is insufficient both for raising worker morale to increase productivity and for influencing strategic decisions that impact employee interests. This part concludes that this model is limited in its ability to explain the most important aspects of new work organization methods. The theory presents the firm as a hierarchical structure designed to prevent shirking. This perspective is too narrow because it fails to address the problem of creating corporate cultures that foster creative and productive behavior.

Coalitions: Corporate Governance as a Multiplayer Game, 78 GEO. L.J. 1495 (1990) (using game theory to analyze stakeholder issues); Lymon Johnson, *Individual and Collective Sovereignty in the Corporate Enterprise*, 92 COLUM. L. REV. 2215 (1992) (urging corporate scholars to broaden their views by incorporating sociology). Other corporate scholars have encompassed critical legal studies perspectives in corporate scholarship. See, e.g., Thomas L. Hazen, *The Corporate Persona, Contract (and Market) Failure, and Moral Values*, 69 N.C. L. REV. 273, 317-18 (1991) (discussing the need to incorporate critical legal studies and feminist scholarship into the nexus of contracts model of the firm); Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 884 (1990) (asserting that “[w]hile corporate law generally has escaped the critical legal studies movement, the takeover debate [may] take on the polarizing overtones of pitting the privileged against the unprivileged.”); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 251 (“Critical scholars . . . have not done nearly enough to apply their theoretical insights to important practical problems.”). For the most part, critical legal studies scholars have not used their tools of deconstruction in the corporate law area. For a critical legal studies perspective of corporate law, see Gerald E. Frug, *The Ideology of Bureaucracy in American Law*, 97 HARV. L. REV. 1276 (1984) (concentrating on the shareholders’ relationship with the corporation); William Simon, *Contract Versus Politics in Corporate Doctrine*, in *THE POLITICS OF LAW* 387 (David Kairys ed., 1990) (discussing the employees’ and the local community’s role in the firm); Charles Watts, *A Race in the Corporate Bastion—A Case in Point* (unpublished manuscript, on file with author) (using critical race theory to argue for reforms to diversify upper-level management). Although feminist scholars have not written widely about corporate law, relational feminism that emphasizes connection and community rather than the narrow pursuit of self-interest offers an important insight into new corporate cultures. For an overview of this work, see CAROL GILLIGAN, *IN A DIFFERENT VOICE* (1988); Robin West, *Jurisprudence and Gender*, 55 U. CHI. L. REV. 1 (1988).

Adolf Berle’s references to Catholic social thought also provide a refreshingly different analysis of the employees’ role in the corporate structure. Berle uses religious metaphors to reconceptualize the manager’s role as a disinterested public servant. See, e.g., ADOLF A. BERLE, JR., *THE TWENTIETH CENTURY CAPITALIST REVOLUTION* (1955); see also Thomas Kohler, *Lessons From the Social Charter: State Corporate Law and the Meaning of Subsidiary*, 43 U. TORONTO L. J. (forthcoming 1993) (describing how Catholic social thought influences the Social Charter in Europe).

Part II uses game-theory models and industrial relations theories to examine the tensions and conflicts that arise from maintaining employee commitment to participatory work programs. This part recognizes that the traditional system of corporate governance provides inadequate protection against the expropriation of firm-specific human capital investments and emphasizes that this makes employees reluctant to accept innovations and disclose information that may decrease employment stability. This part then argues that this lack of protection may jeopardize the long-term success of the new shopfloor practices because workers may respond by reducing effort norms and withdrawing cooperation from the workplace.

Part III builds upon this foundation to consider the implications that the emerging form of labor relations has for issues concerning corporate governance. This part maintains that worker representation on corporate boards is necessary to protect employees' firm-specific investments and to facilitate an atmosphere conducive to a high level of employee trust in volatile economic conditions. This part also asserts that legal intervention is required to implement these changes because the traditional regime of shareholder supremacy and adversarial labor relations discourage individual firms from voluntarily undertaking these internally efficient reorganizations.

Part IV seeks to translate these economic paradigms into a new model of corporate governance entitled the "neutral referee model." Under this proposal, directors would serve as neutral referees to balance the competing interests of shareholders and employees. Directors would owe fiduciary obligations to employees, including the duty to provide information and consult with them about strategic decisions that affect job security and working conditions. In order to facilitate employee efforts to exercise these proposed rights, this part also includes a proposal for Employee Participation Committees modeled upon the German system of works councils. This Article concludes that the neutral referee model would significantly promote efforts to foster labor-management cooperation and meet the demands of international competition.

I

THE EMPLOYEES' ROLE IN THE CORPORATE STRUCTURE:
PARADIGMS IN TRANSITIONA. The Transaction Cost Model of the Firm and the
Employment Relationship1. *Work Organization and Corporate Governance*

The prevailing economic paradigm of the firm, the "nexus of contracts" theory, views the firm as a bundle of implicit and explicit contractual relationships among shareholders, managers, employees, suppliers, the local community, and others.⁶ Oliver Williamson has significantly contributed to this theory by incorporating two assumptions about human behavior. The first assumption, known as "bounded rationality," emphasizes that parties entering into complex, long-term business relationships cannot foresee every possible contingency.⁷ The second assumption, known as "opportunism," focuses on the possibility that one party may attempt to appropriate gains from the transaction at the other's expense. Vulnerability to opportunism increases when parties make transaction-specific investments, because they cannot exit from the contract without forfeiting these investments. Given these transactional barriers, explicit contractual safeguards are often inadequate to govern the parties' relationship; the initial risk distribution process usually requires adjustments to accommodate subsequent events. Thus, the parties leave terms open and attempt to signal their willingness to cooperate in the future by consenting to structures and procedures that will govern their ongoing transactions.⁸ In designing these processes, the parties seek to realign their incentives so that the promise to act fairly in the future is self-enforcing. Devising such processes, however, becomes more difficult as the number of transaction-specific investments and the amount of uncertainty increase.⁹

⁶ This theory builds upon Ronald Coase's seminal theory of firms as cost-efficient alternatives to market transactions. Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937). For a critical evaluation of this theory's influence on corporate law, see William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 *CORNELL L. REV.* 407 (1989).

⁷ See, e.g., OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTI-TRUST IMPLICATIONS* 21-26 (1975) (discussing bounded rationality and uncertainty/complexity).

⁸ See, e.g., OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 163-205 (1985) (discussing how parties attempt to foster trust by giving credible commitments) [hereinafter WILLIAMSON, *CAPITALISM*]; see also Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 83 *AM. ECON. REV.* 519 (1983) (same) [hereinafter Williamson, *Credible Commitments*].

⁹ WILLIAMSON, *supra* note 7, at 52-56.

Williamson uses this transaction cost approach to explain how production is organized within the firm.¹⁰ He asserts that managers and workers agree to delegate power to management over certain issues referred to as the "zones of acceptance."¹¹ This delegation occurs because hierarchical production processes have four efficiency advantages over "peer group" shopfloor practices that involve a higher degree of team effort and worker consultation. First, Williamson suggests that centralized planning under the hierarchical approach reduces the expense involved in organizing day-to-day operations in comparison to peer group methods that seek employee suggestions about changes in production processes.¹² Second, by avoiding the need for employee consent under the peer group method, Williamson asserts that the hierarchical approach provides more flexibility and less uncertainty when it is necessary to adapt production processes to changing market conditions.¹³ Third, Williamson maintains that the hierarchical structure achieves greater efficiency by permitting managers to specialize as monitors to prevent shirking. In contrast, the peer group system creates greater incentives for each team member to shirk because the individual member's input has only a small impact on output.¹⁴ Fourth, Williamson maintains that the "command and control" arrangement under the hierarchical system reduces many of the opportunities for strategic bargaining between managers and employees provided under the peer group method.¹⁵ Therefore, Williamson argues, the dominance of hierarchical shopfloor methods over more participatory models can be explained in terms of lower transaction costs.

Transaction cost economics sheds further light on the nature of the firm by exploring an issue related to work organization—the structure of corporate governance.¹⁶ Under Williamson's model, the firm internalizes transactions characterized by high asset specificity and uncertainty through corporate governance systems.

¹⁰ *Id.* at 155-75.

¹¹ *Id.* at 249 (Hierarchical arrangement provides that management orders concerning these dimensions of production will be implemented without resistance.); see also 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) (Firm hierarchy arises from delegations of power by firm participants acting to reduce transaction costs.).

¹² WILLIAMSON, *supra* note 7, at 45-47.

¹³ *Id.* at 47.

¹⁴ *Id.* at 53-54. Armen Alchian and Harold Demsetz first highlighted the measurement problems that arise when teams of workers cooperate to produce goods. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

¹⁵ WILLIAMSON, *supra* note 7, at 71.

¹⁶ *Id.* at 29, 211 (discussing how measurement problem that occurs in designing work organization is related to issues concerning corporate governance).

Board representation protects firm-specific investments by providing an opportunity to monitor and participate in management of the firm. Williamson asserts that the nature of shareholders' investments requires this type of safeguard because other contractual protections are inadequate.¹⁷ In contrast, Williamson assumes that the employee's investments involve lower asset-specificity and uncertainty, and collective bargaining agreements are sufficient to safeguard their concerns.¹⁸ Williamson recognizes that bounded rationality and opportunism prevent managers and employees from fully protecting their interests through collective bargaining. Therefore, Williamson suggests that the parties develop additional procedural safeguards referred to as "internal labor markets."¹⁹ In general, internal labor markets involve human resource policies concerning job security, training, and job design that impact how production is organized on the shopfloor.²⁰

2. *Internal Labor Markets, Firm-Specific Investments, and Opportunism*

Questions regarding the employees' role in the corporate structure are not appropriate if the employment relationship merely consists of workers exchanging a certain amount of labor for specific market-determined wages. But this is not the case. One-fourth of the total workforce and over half of the male workforce remain at the same firm for at least twenty years.²¹ Labor economists theorize

¹⁷ Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1210 (1984).

¹⁸ *Id.* at 1207-09 (collective bargaining may substitute for labor representation on the board). Katherine Stone criticized Williamson for failing to recognize how the privatized system of collective bargaining that has arisen under the National Labor Relations Act fails to protect labor from the adverse corporate decisions. Katherine Van Wezel Stone, *Labor and the Corporate Structure: Changing Conceptions and Emerging Possibilities*, 55 U. CHI. L. REV. 73, 158 (1988). Williamson does, however, leave open the possibility of labor representation on the corporate board for informational purposes when the academic environment is characterized by a great deal of uncertainty. Williamson, *supra* note 17, at 1209.

Williamson assumes that workers with general purpose skills do not need specific protection because they can easily find employment elsewhere. *Id.* at 1207 ("Such workers can quit and be replaced without productive loss to either the workers or the firm."). Williamson nonetheless recognizes to some extent the harsh consequences faced by displaced workers. *Id.* at 1207 n.31. ("We may want to create some barriers to deter termination without cause and reduce transition costs.")

¹⁹ Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 257 (1979). Williamson suggests that unionization facilitates the development of internal labor markets, but that it is not necessary for these markets to operate successfully. WILLIAMSON, *supra* note 7, at 75-76.

²⁰ See PAUL OSTERMAN, EMPLOYMENT FUTURES: REORGANIZATION, DISLOCATION AND PUBLIC POLICY 60-67 (1988).

²¹ Robert E. Hall, *The Importance of Lifetime Jobs in the U.S. Economy*, 72 AM. ECON. REV. 716, 724 (1982); see also John T. Addison & Albert C. Castro, *The Importance of Lifetime Jobs: Differences Between Union and Nonunion Workers*, 40 INDUS. & LAB. REL. REV.

that large corporations develop internal labor markets that encourage employees to develop long-term attachments to their firms.²² In general, the parties understand that in exchange for an employee's lifetime contribution, the firm will provide a degree of job security. This arrangement involves an "invisible handshake."²³ Although the agreement is not legally enforceable, the parties act "as if" a contract exists.

Firms and workers internalize the employment relationship because external market relationships are inadequate for two reasons. First, external labor markets are not conducive to making investments in human capital. Firms are reluctant to provide training unless they have some assurance that employees will stay with the firm long enough to recoup the returns from the investments. Internal labor markets facilitate firm investments in training by requiring employees to bear part of the expense of acquiring human capital in their junior years.²⁴ That is, firms pay workers wage rates less than their marginal product in their early years and more than their marginal product in their later years. By deferring compensation, internal labor markets provide an incentive for employees to remain with the firm.²⁵

Second, under external market arrangements, firms incur high monitoring costs to reduce shirking because employees tend to perform only according to minimally acceptable standards concerning the quality and quantity of work effort.²⁶ Using Williamson's terms, external market arrangements produce "perfunctory cooperation"

393, 402 (1987) (noting that union workers enjoy a slightly higher tenure, which may be attributable to an informational advantage).

²² Labor economists first use the implicit employment theory to explain the wage rigidity in contemporary labor markets. Three early contributors to the implicit employment contract literature are Costas Azariadis, *Implicit Contracts and Underemployment Equilibria*, 83 J. POL. ECON. 1183 (1975); Martin Baily, *Wages and Employment Under Uncertain Demand*, 41 REV. ECON. STUD. 37 (1974); Donald F. Gordon, *A Neoclassical Theory of Keynesian Unemployment*, 12 ECON. INQUIRY 431 (1974). For an overview of internal labor markets, see, e.g., PETER B. DOERINGER & MICHAEL J. PIORE, *INTERNATIONAL LABOR MARKETS AND MANPOWER ANALYSIS* (2d ed. 1985); RONALD G. EHRENBERG & ROBERT SMITH, *MODERN LABOR ECONOMICS* 421-27 (3d ed. 1988).

²³ See Arthur M. Okun, *The Invisible Handshake and the Inflationary Process*, 22 CHALLENGE 5 (1980).

²⁴ WILLIAMSON, *supra* note 7, at 62-63. Employees are reluctant to bear the expense of acquiring firm-specific human capital because these investments may lose value when the employees lose their jobs. Firm-specific investments in human capital pose the danger that once employees receive firm-specific training, they will "hoard information to their personal advantage." *Id.* at 63. This contracting problem, referred to as "informational asymmetry," intensifies as the degree of asset specificity increases. *Id.* at 63-64.

²⁵ *Id.*

²⁶ Whereas firms tend to be risk-neutral, workers are relatively risk-averse because they face harsh consequences from unemployment if their firm suffers a temporary fluctuation in demand for their labor. Through implicit contracts, firms smooth the workers' income flows through wage rigidity and long-term employment. See Costas

but not “consummate cooperation.”²⁷ In other words, these arrangements induce compliance with work rules but do not lend to additional effort or initiative. Williamson explains that extensive monitoring produces a negative workplace atmosphere, with lower productivity resulting from the “influence of metering intensity on work attitudes.”²⁸ In contrast, internal labor markets attempt to mitigate these problems by establishing “job ladders.” Employees begin their careers at the bottom of these ladders, referred to as “ports of entry,” and climb to higher levels that are not usually open to employees in the general labor market.²⁹ This system of job ladders encourages consummate cooperation by rewarding dedicated, long-term employees with seniority benefits in the form of promotions, higher wages, and job security.³⁰

Because implicit employment arrangements are not legally binding contracts, both parties must rely on extra-legal enforcement mechanisms to ensure that the agreements are fulfilled. Firms deter opportunistic conduct by requiring employees to post bonds in the form of uncompensated labor during the early years of service. These bonds constitute “job market tolls” that the employees must pay in order to enter a job ladder.³¹ These tolls reduce opportunism because employees must surrender these bonds when they quit or are dismissed for poor performance.³² In this way, these job market tolls tend to lock in the employees’ investments in the firm to ensure that they will perform adequately in the future.

Unfortunately, these extra-legal enforcement mechanisms may not prevent firms from reneging on their obligations under implicit labor arrangements. Firms have an incentive to abandon these agreements and expropriate the workers’ share of the firm surplus represented by the deferred compensation and wages that exceed

Azariadis & Joseph E. Stiglitz, *Implicit Contracts and Fixed Price Equilibria*, 98 Q.J. ECON. 1 (1983).

²⁷ WILLIAMSON, *supra* note 7, at 69.

²⁸ *Id.* at 25. Williamson states that the peer group method possesses better sociological attributes, but is inferior to hierarchical alternatives because it fails to assign workers to their most productive uses. See also Oliver E. Williamson, *The Organization of Work: A Comparative Institutional Assessment*, 1 J. ECON. BEHAV. & ORG. 5, 37 (1980) (arguing that nonbierarchical work makes common experience substantial transaction cost disabilities).

²⁹ See DOERINGER & PIORE, *supra* note 22, at 42-47.

³⁰ WILLIAMSON, *supra* note 7, at 78.

³¹ This term originated in Clark KERT, *The Balkanization of Labor Markets*, in LABOR MOBILITY AND ECONOMIC OPPORTUNITY 92 (1954).

³² In addition, employees must give up social contacts at work and may have to change residences. See Thomas Eger & Peter Weise, *Participation and Codetermination in a Perfect and Imperfect World*, in CODETERMINATION: A DISCUSSION OF DIFFERENT APPROACHES 11, 19 (Hans G. Nutzinger & Jurgen Backhaus eds., 1989) [hereinafter CODETERMINATION].

marginal productivity for senior workers. In contrast to the implicit assurances provided by their workers, firms do not bond their performance to employees by providing the financial equivalent of job market tolls. Labor economists explain that these bonds by firms might take the form of severance payments when permanent job loss results from bankruptcy, supply and demand shifts, and product obsolescence.³³ Most firms, however, do not provide severance payments in amounts sufficient to compensate employees for firm-specific investments.³⁴ To a certain extent, employers indirectly bond their performance to employees when they invest in immobile and unsalvageable plant and equipment.³⁵

For the most part, employees are left to rely upon a firm's reputation for upholding implicit employment agreements. Firms that fail to honor these obligations will acquire dishonorable reputations that will impede efforts to attract and retain the most qualified workers. Thus, these reputational sanctions operate both outside the firm in the external labor market and within the firm among the existing employees. In the general labor market, one would presume that the breach of implicit employment agreements would adversely affect a firm's ability to compete for the most productive employees. Yet many labor economists believe that this deterrent is weak because information regarding a firm's untrustworthiness is not sufficiently transmitted throughout the labor market.³⁶ A second feature of the reputational sanction has a more substantial effect. Although most employees are hired on an at-will basis, few employers arbitrarily dismiss workers. Employers value the appearance of an equitable personnel system, which is needed to maintain the morale,

³³ See Sherwin Rosen, *Implicit Contracts: A Survey*, 23 J. ECON. LIT. 1144, 1170-71 (1985).

³⁴ See Robert E. Hall & Edward P. Lazear, *The Excess Sensitivity of Layoffs and Quits to Demand*, 2 J. LAB. ECON. 233, 250 (1984) (Because firm has monopsony power, some degree of severance pay is desirable to offset that power.). Attempting to explain why corporations often fail to provide severance payments, economists surmise that "the temptation for the firm to renege on promised severance payments may be irresistible." Larry Samuelson, *Implicit Contracts with Heterogenous Labor*, 3 J. LAB. ECON. 70, 87 (1985) (Implicit contract models often allow firms to make severance payments "presumably because of the optimality of doing so."). In defending employment-at-will, Richard Epstein recognizes that severance pay has advantages. Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 967 (1984).

³⁵ In addition, firms individually bond their performance through investments in the hiring and training of new workers. See Clive Bull, *Implicit Contracts in the Absence of Enforcement and Risk Aversion*, 73 AM. ECON. REV. 658, 662-63 (1983); William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385, 392 (1990).

³⁶ See, e.g., Carl Shapiro & Joseph E. Stiglitz, *Equilibrium Unemployment as a Worker Discipline Device*, 74 AM. ECON. REV. 433, 442 (1984) (contending that prospective employees often do not know the employer's record, and previous dismissals may have been legitimate).

productivity, and loyalty of the current workforce.³⁷ Although the firm's interest in maintaining its reputation as a fair employer provides some assurance to employees, significant room for opportunistic conduct by firms remains. Because employees lack adequate safeguards to prevent the expropriation of their firm-specific investments, the successful operation of an internal labor market within a firm depends upon the degree that the workforce trusts that management will not renege on its obligations under implicit employment agreements.

B. Restructuring Internal Labor Markets: Emerging Shopfloor Practices

During the past twenty years, internal labor markets have been undergoing a transformation on a world-wide scale as firms respond to international market pressures by reshaping shopfloor practices.³⁸ Many corporations have shifted from the conventional bureaucratic form of work organization to more flexible, participatory work programs.³⁹ In general, large nonunionized firms employ the participatory model, while the unionized steel and auto industries have used the hierarchical system.⁴⁰

The traditional system, known as "Taylorism,"⁴¹ seeks to maximize productivity by developing a high degree of specialization among workers.⁴² In general, this system separates "thinking" work from "doing" work in order to develop technical expertise.⁴³ To

³⁷ See, e.g., Bull, *supra* note 35, at 662; Azariadis & Stiglitz, *supra* note 26, at 19.

³⁸ Masahiko Aoki, *The Participatory Generation of Information Rents and the Theory of the Firm*, in *THE FIRM AS A NEXUS OF TREATIES* 26, 27 (Masahiko Aoki et al. eds., 1990) [hereinafter TREATIES].

³⁹ Eighty percent of the Fortune 1000 companies have implemented some form of the participating work program. *Current Developments*, Daily Lab. Rptr. (BNA) No. 186, at A-9 (Sept. 27, 1989).

⁴⁰ See, e.g., CHARLES C. HECKSCHER, *THE NEW UNIONISM: EMPLOYEE INVOLVEMENT IN THE CHANGING CORPORATIONS* 97 (1988) (For the most part, companies implementing participatory programs seek to avoid unionization, although General Motors and Ford are notable exceptions.).

⁴¹ These shopfloor practices began in the early twentieth century when industrial engineer Frederick W. Taylor devised the method of production referred to as "scientific management." FREDERICK TAYLOR, *THE PRINCIPLES OF SCIENTIFIC MANAGEMENT* (1911). For a detailed historical account of Taylorism, see DANIEL NELSON, *FREDERICK W. TAYLOR AND THE RISE OF SCIENTIFIC MANAGEMENT* (1980).

⁴² TAYLOR, *supra* note 41, at 32; see also HARRY BRAVERMAN, *LABOR AND MONOPOLY CAPITAL: THE DEGRADATION OF WORK IN THE TWENTIETH CENTURY* 126 (1974) ("The separation of hand and brain is the most decisive single step in the division of labor taken by the capitalist mode of production.").

⁴³ See, e.g., DAN CLAWSON, *BUREAUCRACY AND THE LABOR PROCESS: THE TRANSFORMATION OF U.S. INDUSTRY, 1860-1920* 202 (1980) (describing Taylor as "the Napoleon of the war against craft production"); REICH, *supra* note 1, at 68 ("Planning was to be distinct from execution, brain distinct from brawn, head from hand, white collar from blue collar."); Katherine Stone, *The Origins of Job Structures in the Steel Industry*, in *LABOR MAR-*

accomplish this task, the production process is segmented into independent work assignments involving simple, repetitive motions that minimize the amount of judgment required by workers. Under Taylorism, decisionmaking takes place through a centralized managerial planning department.⁴⁴ The ultimate managerial authority rests at the top of a pyramid-shaped hierarchy. At the lower levels of this pyramid, managerial discretion is constrained by rigid work rules. This hierarchical system stresses the importance of preserving managerial control over the production process by reducing the firm's dependence upon labor cooperation. To ensure control, Taylorism employs extensive monitoring based on the assumption that workers will shirk their duties when given the opportunity.⁴⁵ In addition, jobs are defined narrowly so that workers are prevented from understanding the production process so that they cannot reduce the pace of work and the amount of production.⁴⁶ In order to minimize the risk that workers will limit production, Taylorism seeks to inhibit worker solidarity by using discrete job assignments that reduce the need for communication between employees. For these reasons, Taylorism tends to produce an adversarial atmosphere that leads to a low level of employee commitment.⁴⁷

Despite the employee alienation it engenders, Taylorism successfully operated in the stable oligopolistic markets that existed in the United States during the 1950s and 1960s.⁴⁸ During the 1970s, however, this economic environment changed as global market pressures reduced the competitiveness of the traditional mass production industries in highly developed economies.⁴⁹ Comparative advantages for firms in industrialized nations have since shifted to more specialized production methods that are characterized by frequent technological change and shorter product cycles.⁵⁰ Taylorism, however, is not well-suited to respond to these developments. Routinized production processes and fixed job classifications impede firm efforts to respond quickly to new opportunities in a rapidly changing environment. Thus, use of the traditional system in

KET SEGMENTATION 27 (Richard C. Edwards et al. eds., 1975) (employer strategies designed to gain and maintain control over the work process).

⁴⁴ See, e.g., TAYLOR, *supra* note 41, at 65; BRAVERMAN, *supra* note 42, at 136.

⁴⁵ See, e.g., REICH, *supra* note 1, at 64.

⁴⁶ See, e.g., BRAVERMAN, *supra* note 42, at 125 ("Thus, in the setting of antagonistic social relations, of alienated labor, hand and brain become not just separated, but divided and hostile, and the human unity of hand and brain turns into its opposite, something less than human.").

⁴⁷ *Id.*

⁴⁸ See PIORE & SABEL, *supra* note 1, at 165-66.

⁴⁹ See REICH, *supra* note 1, at 127.

⁵⁰ Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LIT. 1, 4 (1990).

the United States is gradually declining as firms realize that competing in the global economy requires a high commitment to flexible shopfloor practices.⁵¹

In redesigning production processes, many firms in the United States have looked to the Japanese system of industrial relations. Although the new practices differ widely among individual firms, the emerging form of work organization generally attempts to raise productivity by utilizing rather than suppressing worker knowledge.⁵² Whereas Taylorism tends to stress passive obedience to rigid work rules, these new programs entrust workers with increasing amounts of responsibility in the interests of the company. Avoiding the time delay caused by hierarchical planning, these programs delegate control over production processes to workers on the shopfloor where useful on-the-spot information is available.⁵³ In contrast to their narrow job assignments under Taylorism, workers in the emerging programs learn a variety of skills that allow them to rotate among positions according to the firm's needs.⁵⁴ In this way, these programs develop the worker's problem-solving capabilities by sharing knowledge on the shopfloor. By avoiding rigid, hierarchical chains of authority,⁵⁵ participating programs allow firms to respond more quickly to market signals.⁵⁶ Compared to Taylorism, these programs use relatively "flat" organizational structures because autonomous work teams perform many functions previously controlled by managers.⁵⁷

C. Participatory Work Programs and the Transaction Cost Model of the Firm

The transaction cost model of the firm provides a framework to understand the implications that the recent changes in shopfloor practices have for the structure of internal labor markets that operate within firms. Although the transaction cost model provides a useful analysis of certain features of the emerging methods of work organization, it contains several drawbacks. Exploring these weaknesses reveals ways in which the prevailing theory of the firm needs

⁵¹ Michael Piore and Charles Sabel described the changing shopfloor practice as "flexible specialization." This is the term given to efforts "[t]o convert the traditional highly integrated corporate structure into a more supple organizational form capable of responding quickly to shifting market conditions and product demand." *PIORE & SABEL, supra* note 1, at 231-36.

⁵² Aoki, *supra* note 38, at 27.

⁵³ *Id.* at 27; Aoki, *supra* note 50, at 3.

⁵⁴ Aoki, *supra* note 38, at 43.

⁵⁵ *Id.*

⁵⁶ *Id.* at 27.

⁵⁷ REICH, *supra* note 1, at 246.

to be revised to provide a richer and more complex view of the employees' changing role in the corporate structure.

1. *The Efficiency Tradeoffs of Participatory Work Programs*

Williamson's vision of the employment relationship parallels the Taylorist view. In transaction cost terms, Taylorism reduces the potential for opportunism by preventing workers from developing an informational advantage concerning operational processes.⁵⁸ In addition, Taylorism's strong emphasis upon control ensures that managers maintain a strategic advantage over production matters. Williamson maintains that the separation of "thinking" from "doing" achieves efficiencies because "information-processing and decision-making talents are not widely distributed."⁵⁹ He builds upon this assumption to assert that a positive correlation exists between efficiency and hierarchy. Specifically, Williamson maintains that "centralization of information handling avoids the need for full group discussion with little or no sacrifice in the quality of the decision."⁶⁰ Williamson, however, recognizes that hierarchial work structures may have a negative impact on worker incentives and recommends that future research should focus upon issues of employee dignity and workplace atmosphere.⁶¹

⁵⁸ Stone, *supra* note 43, at 19.

⁵⁹ Williamson suggests:

What is especially relevant to the choice of peer group or simple hierarchy is that, to the extent that the requisite information-processing and decision-making talents are not widely distributed, efficiency will be served by reserving the central information collection and decision-making position to the one or few individuals who have superior information processing capacities and exceptional oratorical and decision-making skills. Something of an elite thereby results, as the select set bears an asymmetrical relation to everyone else.

WILLIAMSON, *supra* note 7, at 52.

⁶⁰ *Id.* at 46-47. Williamson states:

[S]uppose that adaptations to changing market circumstances are needed in order to utilize resources efficiency. While a full group discussion could be held to determine what adaptation is to be made, this is time consuming and may yield little gain if—provided only that everyone pulls in harness—any of a number of adaptations would work.

Id. at 47; see also WILLIAMSON, CAPITALISM, *supra* note 8, at 231, 239 (correlation between the degree of hierarchy and efficiency). In response to the claim that hierarchy arises because of the need to maintain control over workers, Williamson considers hierarchy to be a generic element of the firm as an alternative to market transactions. He asserts: "[h]ostility to hierarchy thus lacks a comparative institutional foundation. There may be more or less preferred types of hierarchy; but hierarchy itself is unavoidable unless efficiency sacrifices are made." *Id.* at 231.

⁶¹ Williamson recognizes that Taylorism creates a calculating atmosphere that leads employees to perform their jobs in a minimal or "perfunctory" rather than a maximal or "consummate" fashion. He indicates that participatory programs create a better atmosphere for workplace cooperation because less monitoring increases the workers dignity. He states that peer group production fosters a better atmosphere because it allows the

Although Williamson acknowledges that the peer group form of production provides advantages for the workers' dignity, he expresses great doubt that participatory work programs will achieve greater productivity.⁶² At this point, conflicting empirical data prevent a definite conclusion about the efficacy of the new shopfloor practices.⁶³ Williamson suggests that the positive impact upon atmosphere under participatory programs is outweighed by losses that result from the reduction in the specialization of jobs and centralization in decisionmaking.⁶⁴ When environments for planning are stable, this may be the case. That is, the information acquired on the shopfloor may not enhance centralized planning.⁶⁵ Yet, the opposite situation arises when fluctuating market conditions require a flexible and creative workplace to respond rapidly to new production processes. Under these conditions, the benefits gained by greater communication at the shopfloor level under participatory programs may more than compensate for the loss of skill specialization that results as a consequence of the workers' time spent in acquiring new information.⁶⁶

2. *Transaction Hazards and Participatory Work Practices*

Compared to Taylorism, emerging shopfloor practices require workers to invest in more firm-specific skills by developing their capacity to communicate information about production processes and adapt to flexible work assignments. Yet, under current market conditions, employees face a great deal of uncertainty when making these additional investments. Specifically, employees fear that abandoning rigid work rules and sharing information about production inefficiencies will lead to layoffs.⁶⁷ This fear is understandable given the existing structure of internal labor markets. In stable economic

"transformation of 'involvement' relations, from a calculative to a more nearly quasimoral mode. . . ." WILLIAMSON, *supra* note 7, at 44. Williamson also argues that unless problems of alienation and workers' "dignity" are considered, the conception of economic organization will be too narrow. WILLIAMSON, CAPITALISM, *supra* note 8, at 271 ("[C]apitalism is prone to undervalue dignity and that institutional safeguards can sometimes be forged that help to correct the condition.").

⁶² WILLIAMSON, CAPITALISM, *supra* note 8, at 270 ("Participation benefits raises a serious doubt that efforts to effect participation can be justified on profitability grounds.").

⁶³ *Id.* at 269-70 (discussing conflicting studies).

⁶⁴ *Id.* at 270.

⁶⁵ Aoki, *supra* note 38, at 8-10.

⁶⁶ *Id.*

⁶⁷ THOMAS A. KOCHAN ET AL., WORKER PARTICIPATION AND AMERICAN UNIONS: THREAT OR OPPORTUNITY? 42, 58-59 (1984) (Employees resist cooperating with innovations in the workplace for fear of job loss.) [hereinafter KOCHAN ET AL., WORKER PARTICIPATION]; KOCHAN ET AL., *supra* note 1, at 119 (new work structures spur employee interest in job security).

environments, self-enforcing mechanisms concerning firms' reputations adequately prevent them from breaching implicit employment agreements. However, the results of highly leveraged, bust-up acquisitions dramatically illustrate the insufficiency of these extra-legal measures to prevent the expropriation of human capital investments.⁶⁸ Reputational concerns are also unlikely to protect employees when a firm leaves a regional labor market and relocates to another part of the country or world.⁶⁹ As the labor market becomes more volatile, long-term employment relationships become less secure.⁷⁰ This instability frustrates attempts to reform shop-floor practices and undermines the essential foundation needed for the successful operation of internal labor market arrangements—worker trust.

Because participatory programs raise employee concerns about job security, firms using the new shopfloor practices will either have to pay workers a wage premium to compensate for this risk or reduce the risk of opportunism. Competitive pressures may foreclose the option of paying higher wages. Thus, firms will need to develop transactional safeguards to ensure that employees will receive the benefits of their firm-specific investments without fear of exploitation. However, the traditional collective bargaining solution fails to accomplish this task for two reasons. First, collective bargaining will not induce employees to engage in cooperative efforts to improve productivity and product quality. This kind of participation simply cannot be written into detailed, contractual specifications. Second, as the employment structure becomes more deeply internalized, the employees' welfare becomes increasingly influenced by strategic decisions involving job security, production processes, and investment rates. Yet, these issues 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 oppor-

⁶⁸ Sherwin Rosen, *Transaction Costs and Internal Labor Markets*, 4 J.L. ECON. & ORG. 49, 51 (1988) (discussing *ex post* enforcement problem due to opportunistic breach); Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 38 (Alan J. Auerbach ed., 1988) ("[I]mplicit contracts specify actions that *ex post* reduce the firm's value, even though agreeing to these actions is *ex ante* value maximizing. Breach of contract can therefore raise shareholder wealth, and the more so the greater is the burden of fulfilling past implicit contracts."). *Id.* at 38.

⁶⁹ Shleifer & Summers, *supra* note 68, at 39 (stating that an employer whose future reputation is unimportant is likely to breach implicit agreements with employees).

⁷⁰ See, e.g., BENNETT HARRISON & BARRY BLUESTONE, *THE GREAT U-TURN: CORPORATE RESTRUCTURING AND THE POLARIZING OF AMERICA* 112-28 (1988) (discussing how restructuring produces widespread alienation in the workplace); OSTERMAN, *supra* note 20, at 80 ("[W]orkers generally will feel less secure as they confront an economy in which more of their neighbors, friends, and relatives are having trouble.").

tunistic conduct impede efforts to protect employees against every contingency in explicit contracts. Viewed in this light, collective bargaining alone is insufficient to meet the needs of contemporary labor relations in a changing world economy.

Under Williamson's analysis, workers should be granted a role in corporate governance because participatory work programs require employees to make investments characterized by high asset specificity and uncertainty. In two respects, however, the transaction cost model fails to analyze the type of relational contracting that is necessary for participatory work programs to succeed. First, although Williamson asserts that internal labor markets create a workplace atmosphere that motivates workers to provide consummate cooperation,⁷¹ Williamson never provides a detailed explanation of why this result should occur. Second, Williamson focuses almost exclusively upon the employers' problems controlling employee opportunism involving shirking. He tends to ignore employees' difficulties concerning firm opportunism, particularly the fact that internal labor markets fail to prevent the expropriation of workers' firm-specific investments.

To further explore the emerging shopfloor practices, we need to shift the discussion of implicit employment agreements away from the traditional goal of preventing shirking and toward the more pressing problem of developing organizational arrangements that are best suited to motivate a highly committed workforce to utilize fully their information-processing and communicative abilities. It is also necessary to focus upon the industrial conflict that surrounds the implementation of participatory work programs by analyzing the consequences of opportunistic conduct by both employers and workers. The next part explores these issues by developing a revised economic framework that incorporates literature in the areas of strategic games, industrial relations, and relational contracts.

II

PARTICIPATORY WORK PROGRAMS: AN X-EFFICIENCY PERSPECTIVE

A. X-efficiency, the Prisoners' Dilemma, and Effort Conventions

As the concept of the firm is expanded to encompass the employees' changing role, the concept of efficiency needs to be broadened accordingly. Economist Harvey Leibenstein examines the workers' ability to influence the internal efficiency of the firm's oper-

⁷¹ WILLIAMSON, *supra* note 7, at 38-39.

ations.⁷² Leibenstein begins with the premise that firms cannot purchase labor like other factors of production. Although firms buy worker time, the relevant consideration for productivity is the pace and quality of the worker effort.⁷³ To a certain extent, employers can control these factors by monitoring minimum standards and imposing sanctions for shirking. Above minimum standards, however, workers have discretion to produce at higher levels.⁷⁴ In particular, monitoring will not ensure that workers reveal information concerning production inefficiencies.⁷⁵ The way the firm treats its employees significantly influences the "X-factor"; that is, how inner-motivated workers are to cooperate and produce. Within a certain range, managers can modify worker incentives through wages and working conditions.⁷⁶ Leibenstein explains that ignoring those motivational considerations leads to a substantial amount of "X-inefficiency."⁷⁷ As a result, this theory suggests that productivity may differ among firms even if the other aspects of production are the same.⁷⁸

To demonstrate the implications of X-inefficiency, Leibenstein regards productivity as a prisoners' dilemma game played by employees and managers making strategic decisions that are characterized by both conflicting and common goals.⁷⁹ Under this game, workers and managers make basic choices about whether to cooperate or defect in deciding the amount of work effort and the quality of working conditions. Of course, the optimal solution involves employees choosing to provide the highest level of effort in return for the best working conditions. Yet, the players face difficulties in reaching the optimal solution because they cannot credibly commit to achieve this outcome by using traditional explicit and implicit contractual safeguards.

⁷² HARVEY LEIBENSTEIN, *INSIDE THE FIRM: THE INEFFICIENCIES OF HIERARCHY* 32 (1987) [hereinafter *LEIBENSTEIN, INSIDE THE FIRM*]; HARVEY LEIBENSTEIN, *BEYOND ECONOMIC MAN: A NEW FOUNDATION FOR MICROECONOMICS* 29 (1976) [hereinafter *LEIBENSTEIN, BEYOND ECONOMIC MAN*]. For a comparison of the X-efficiency model and the transaction cost model, see Louis De Alessi, *Property Rights, Transaction Costs, and X-Efficiency: An Essay in Economic Theory*, 73 *AM. ECON. REV.* 64, 76 (1983) (criticizing Leibenstein's model by asserting that X-inefficiency can be described in terms of transaction costs); Louis De Alessi, *Property Rights and X-Efficiency: A Reply*, 73 *AM. ECON. REV.* 843 (1983) (same).

⁷³ *LEIBENSTEIN, BEYOND ECONOMIC MAN*, *supra* note 72, at 98-99.

⁷⁴ *Id.* at 98-100; *LEIBENSTEIN, INSIDE THE FIRM*, *supra* note 72, at 99.

⁷⁵ *LEIBENSTEIN, INSIDE THE FIRM*, *supra* note 72, at 101-02.

⁷⁶ *Id.* at 87.

⁷⁷ *LEIBENSTEIN, BEYOND ECONOMIC MAN*, *supra* note 72, at 46-47, 94.

⁷⁸ *Id.* at 100-01; *LEIBENSTEIN, INSIDE THE FIRM*, *supra* note 72, at 104.

⁷⁹ For an introduction to game theory and the prisoners' dilemma see, e.g., DAVID M. KREPS, *GAME THEORY AND ECONOMIC MODELLING* 29-39 (1990); ERIC RASMUSEN, *GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY* 27-30 (1979).

On the one hand, employees face difficulty in giving credible commitments to provide consummate cooperation because cost considerations prevent firms from detecting the amount of the workers' effort. Additionally, heavy monitoring creates a negative work atmosphere that decreases productivity. Given these limitations, firms could require employees to sacrifice a bond for failing to perform according to the highest standards. However, this solution would fail because employees probably lack the resources to provide these bonds in amounts sufficient to guarantee consummate cooperation.⁸⁰

Employers also face barriers in providing credible commitments for employment security. A widely accepted notion is that employers do not offer complete job security because it would cause employees to shirk.⁸¹ Yet, this "moral hazard" theory seems odd because it is unlikely that a firm would ever agree to retain workers who do not meet minimum performance standards. A better explanation suggests that employers' inability to provide credible commitments arises as a result of the transaction costs involved in drafting and enforcing contracts for job security.⁸²

Because transaction costs impede efforts to make credible commitments, a party who chooses to cooperate when playing the prisoners' dilemma game has no assurance that the other player will respond in a similar fashion. If both players cooperate, each receives a higher payoff than if both defect. But if one player defects while the other cooperates, the defecting player receives the highest return available, while the cooperating player receives the lowest return possible. Under this game, the dilemma arises because each player has an opportunity to receive the larger return at the other's expense by exploiting trusting behavior. Because each player is un-

⁸⁰ Roger McCain, *Transaction Costs, Labor Management, and Codetermination*, 4 ADVANCES ECON. ANALYSIS OF PARTICIPATORY AND LABOR MANAGED FIRMS 205, 213 (1992) (discussing commitment problems); cf. George A. Akerlof & Lawrence F. Katz, *Workers' Trust Funds and the Logic of Wage Profiles*, 104 Q.J. ECON. 525 (1989) (during the early years of service, the amount of the bond may be insufficient to provide much deterrence against shirking; thus, deferred payment scheme and up-front bonds are not perfect substitutes); Alan Hyde, *In Defense of Employee Ownership*, 67 CHI.-KENT L. REV. 159 ("Real world employees obviously do not have the resources to post such a bond.").

⁸¹ See, e.g., Jensen & Meckling, *supra* note 11, at 363; see generally Williamson, *Credible Commitments*, *supra* note 8, at 519-20 (reporting that a mechanism designed to control the opportunism of one party may well facilitate the opportunism of the other).

⁸² In drafting tin parachutes, Katherine Stone explains, it is difficult to specify all the events that would trigger the parachute. Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45, 60-64 (1991). Even if these contracting problems could be overcome, Stone explains that successorship rules prevent unions from enforcing provisions in the event of certain changes in control. *Id.* at 64. Enforcement is also impeded because arbitrators are reluctant to grant injunctive relief. *Id.* at 67.

certain how the other will behave, distrust leads each player to pursue the strategy that maximizes individual gain while reducing the risks of opportunism. Under this strategy, each player perceives that, regardless of whether the other player decides to cooperate or defect, the decision to defect will produce a higher return than the decision to cooperate. This type of reasoning leads each player to defect, producing an inferior outcome for both parties referred to as the "prisoners' dilemma solution."

Applying this analysis to productivity, Leibenstein explains that firms have an incentive to increase profits by obtaining the maximum amount of work effort at the lowest cost in terms of working conditions. Similarly, workers have an incentive to obtain the best working conditions in return for the lowest amount of effort possible. Under the prisoners' dilemma solution, employees supply the lowest effort possible, regardless of the motivations provided by managers. Similarly, managers will provide low motivations, regardless of the effort put forth by employees.⁸³ In contrast, if the parties trust each other to cooperate, it is possible to attain the "golden rule solution," in which employees provide maximum effort in return for optimal working conditions and wages.⁸⁴

Leibenstein suggests that the prisoners' dilemma solution rarely occurs because the parties establish conventions regarding the appropriate amount of effort and working conditions.⁸⁵ Certain factors influence these "effort conventions," including the motivational forces operating within the firm, such as the plant's history of industrial relations. These conventions are also affected by motivational forces operating outside the firm such as the degree of competition.⁸⁶ Once performance patters become routine, Leibenstein maintains that effort conventions become quite stable.⁸⁷ Workers as a group assure adherence to the effort convention by training new workers and applying social pressures for conformity.⁸⁸ In this way,

⁸³ LEIBENSTEIN, *INSIDE THE FIRM*, *supra* note 72, at 50.

⁸⁴ *Id.* at 96-97.

⁸⁵ *Id.* at 77-78. When a game has multiple possible solutions, the one chosen may depend upon conventional standards of behavior. A convention "is basically an agreed-upon regularity of behavior appropriate within a certain set of contexts." *Id.* at 70. Following a convention is a "nonthinking, passive decision." *Id.* at 88. This behavior is "stimulus-response" behavior. *Id.* at 83. For further discussion of how conventions solve coordination games, see KREPS, *supra* note 79, at 65; *see also* ANDREW SCHOLLTER, *THE ECONOMIC THEORY OF SOCIAL INSTITUTIONS* 11 (1981).

⁸⁶ LEIBENSTEIN, *INSIDE THE FIRM*, *supra* note 72, at 68.

⁸⁷ *Id.* at 71.

⁸⁸ *Id.* at 81; *see also* Aoki, *supra* note 50, at 26 ("Work customs generated and owned collectively are transferable to new workers through 'social cohesion and group pressures' rather than the market."). Some coordinating conventions do not need much enforcement. One example is driving on the right-hand side of the road. People follow this social practice in a non-instrumentally rational way. Yet, in the prisoners' dilemma,

effort conventions that solve the prisoners' dilemma also solve the free rider problem concerning an individual worker's incentive to shirk when evaluated upon team performance.⁸⁹

Although conventions regarding the level of work effort and the quality of working conditions are normally sufficient to avoid the prisoners' dilemma, Leibenstein asserts that these conventions usually fall far below those reached under the golden rule solution.⁹⁰ In other words, a considerable amount of X-inefficiency exists within firms in the United States due to adversarial labor relations. Supporting this view, a recent study by the MIT Commission on Industrial Relations emphasizes the lack of labor-management cooperation as a significant factor for low productivity in the United States.⁹¹

Suboptimal conventions are unlikely to change unless managers and workers learn to recognize and avoid the prisoners' dilemma problem. Leibenstein suggests that this is unlikely to occur in the absence of outside pressure because the inertia inherent in employment relationships creates disincentives to change established conventions.⁹² External market forces, however, tend to push the parties to foster "cultural change" that promotes higher effort norms.⁹³ Similarly, industrial relations experts maintain that crisis periods may be necessary to inspire labor-management cooperation to raise productivity.⁹⁴

incentives exist to cheat. Thus sanctions are necessary to ensure that people abide by the convention that avoids the prisoners' dilemma solution. Leibenstein suggests that new workers will follow effort norms set by the workers as a group, even if the group effort convention conflicts with the orders received from management. LEIBENSTEIN, *INSIDE THE FIRM*, *supra* note 72, at 74-75.

⁸⁹ *Id.* at 57.

⁹⁰ *Id.* at 75-76; *see also* Aoki, *supra* note 50, at 26 ("[A]s a result of subsequent development of technology in the society at large, conflicts between work customs and efficiency may arise, and once-efficient customs may be turned into 'collective bads' from the viewpoint of the firm.").

⁹¹ MICHAEL DERTOUZOUS ET AL., *MIT COMMISSION, MADE IN AMERICA: REGAINING THE PRODUCTIVE EDGE* 111, 140 (1989) (arguing that underdeveloped cooperation is a major obstacle to technological innovation and the improvement of industrial performance); *see also* COMMISSION ON WORKFORCE QUALITY AND LABOR MARKET EFFICIENCY, U.S. DEPARTMENT OF LABOR, *INVESTING IN PEOPLE* (1989) (same); DANIEL YANKELOVICH & JOHN IMMERWAHR, *PUTTING THE WORK ETHIC TO WORK: A PUBLIC AGENDA REPORT ON RESTORING AMERICA'S COMPETITIVE VITALITY* 25-30 (1983) (workers discuss a "commitment gap" between their performance and the optimal level of performance).

⁹² LEIBENSTEIN, *INSIDE THE FIRM*, *supra* note 72, at 73; LEIBENSTEIN, *BEYOND ECONOMIC MAN*, *supra* note 72, at 111-13.

⁹³ LEIBENSTEIN, *INSIDE THE FIRM*, *supra* note 72, at 59, 73.

⁹⁴ *See, e.g.*, KOCHAN ET AL., *supra* note 1, at 13-15 (periods of significant strategic adjustment give rise to a wider variety of choices and experiments); Jack Barbash, *Do We Really Want Labor on the Ropes?*, *HARV. BUS. REV.*, July-Aug. 1985, at 10 ("Hard times" may be the essential condition of cooperation).

By emphasizing how productivity depends upon strategic interactions between managers and employees, Leibenstein captures significant aspects of the employment relationship that labor economists often ignore. Specifically, the theory of effort conventions explains why internal labor markets alone may not necessarily promote consummate cooperation. Accordingly, Leibenstein's X-efficiency theory provides the basis to assess how participatory work programs have changed the rules of the productivity game within firms.

B. Participatory Work Programs and the Changing Nature of the Productivity Game

Leibenstein's framework suggests that although Taylorism creates worker alienation and low effort norms,⁹⁵ firms had few incentives to reduce X-inefficiency when the United States was mostly isolated and economically unrivaled. Global market pressures, however, have pushed firms to raise effort conventions by providing higher motivations for workers through participatory work programs. Once effort conventions are destabilized, however, it is not clear whether strategic bargaining between managers and workers over the dynamics of readjustment will lead to a superior or inferior solution for both players, or an outcome under which one player benefits at the other's expense. On the one hand, new shopfloor practices create an opportunity to reach the golden rule solution if workers raise effort norms and employers offer better working conditions. On the other hand, participatory work programs may result in greater X-inefficiency because the players can move in the opposite direction towards the prisoners' dilemma solution: employees may withdraw their commitment to the workplace if they perceive incentive patterns as inadequate and firms can respond to lower effort norms by adopting less desirable work arrangements in order to maintain control.⁹⁶

Thus, although managers and employees are beginning to see the need for cooperation to increase productivity, the prisoners' dilemma problem still exists because each side must trust the other to fulfill the terms of the new implicit employment arrangements. This section analyzes the changing nature of the productivity game and the factors that may influence how managers and employees will adapt to the new rules under participatory work programs.

⁹⁵ LEIBENSTEIN, *INSIDE THE FIRM*, *supra* note 72, at 56 (Taylorism "saw only half the picture" by missing motivational factors and prisoners' dilemma aspects of production.).

⁹⁶ *Id.* at 58.

1. *The Additional Risks of Opportunism*

One of the most significant developments in the productivity game has not received much attention. Compared to Taylorism, participatory work programs involve a shift in control over production decisions by providing employees on the shopfloor with more bargaining power in three ways.⁹⁷ First, participatory work programs depend upon a highly committed and flexible workforce. Thus, the employees' ability to establish effort norms has a significant impact upon productivity.⁹⁸ Second, employees as a group gain additional leverage because these programs require workers to develop firm-specific skills. Consequently, it is more difficult for the firm to replace these workers.⁹⁹ Third, "high-discretion" workplaces provide opportunities to develop an informational advantage concerning production processes.¹⁰⁰ Thus, viewing the game from the firm's perspective, managers face a great deal of risk in implementing participatory work programs because these sources of power provide workers with greater ability to threaten to withhold their cooperation when firms become dependent on the workers' flexibility and knowledge.¹⁰¹ Although employers have no assurance of consummate cooperation, the internal labor market provides employers with some protection against opportunistic conduct because employees bond a certain level of performance by accepting lower wages during their early years of service.¹⁰²

The higher risks of exploitation under participating work programs run the other way as well. These new shopfloor practices frequently require workers to make additional investments in firm-specific knowledge that increase the difference in opportunity costs between working for the given firm and the next best alternative. As these opportunity costs increase, the workers' vulnerability to opportunism also rises. Specifically, after workers acquire these skills, the firm may renege on the implicit agreement by reducing working conditions to the level provided to workers without these abilities.¹⁰³

⁹⁷ Aoki, *supra* note 50, at 25.

⁹⁸ *Id.* at 32.

⁹⁹ *Id.* at 102.

¹⁰⁰ *Id.* at 54.

¹⁰¹ See, e.g., William H. Simon, *The Politics of Cooperation in the Workplace*, RECONSTRUCTION, Winter 1990, at 18, 22 (participatory programs provide workers with more power).

¹⁰² See *supra* notes 31-32 and accompanying text.

¹⁰³ Jonathan Macey notes:

Unlike high-level managers, who make firm-specific human capital investments as individuals, rank-and-file workers are often trained as groups and make firm specific human capital investments simultaneously with their co-workers. This arrangement contains additional potential for ex-

Compared to the safeguards that internal labor markets provide employers, workers have significantly less protection from opportunistic conduct by firms. When firms change their production practices, workers lose safeguards previously provided under Taylorism. Specifically, the routinized production processes of Taylorism restrain the firm's ability to reduce the workforce during a period of low demand. Additionally, the uniform enforcement of rigid work rules restricts arbitrary decisionmaking at lower managerial levels.¹⁰⁴ Workers are reluctant to give up these protections because they fear that participatory work programs may lead to job loss and more intense work standards, commonly referred to as "speed ups."¹⁰⁵ Once firms establish participatory programs, however, employees gain some security because the new shopfloor practices make it difficult to replace team members. Although workers gain some protection, significant room for opportunistic conduct by firms remains.

Two factors compound the employees' risk. First, managers have an informational advantage concerning the employees' impact on firm profitability. This informational asymmetry causes employees to be suspicious of managements' motives in implementing participatory work programs. This skepticism toward management initiatives is often reinforced when the strategic policies decided at the highest level of the firm adopt an adversarial approach to labor relations while seeking to promote a cooperative atmosphere on the shopfloor.¹⁰⁶ For example, many firms using new participatory techniques simultaneously engage in egregious unfair labor practices.¹⁰⁷ Such actions lead workers to fear that managers may attempt to take an excessive share of the firm surplus by announcing that production is less than it actually is in order to steadily raise work requirements and decrease working conditions.¹⁰⁸ The sec-

ploitation, because firms enjoy economies of scale in hiring and training workers.

Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 191.

¹⁰⁴ The use of the rigid enforcement of job rules is referred to as "job control unionism." See, e.g., BRAVERMAN, *supra* note 42, at 96-100; Michael J. Piore, *American Labor and the Industrial Crisis*, CHALLENGE, Mar.-Apr. 1982, at 25.

¹⁰⁵ See, e.g., GUILLENMU J. GRENIER, *INHUMAN RELATIONS: QUALITY CIRCLES AND ANTI-UNIONISM IN AMERICAN INDUSTRY* (1988) (cooperative programs used to reduce the influence of unions); MIKE PARKER & JANE SLAUGHTER, *CHOOSING SIDES: UNIONS AND THE TEAM CONCEPT 5* (1988) (describing management pressure tactics used to force workers to accept cooperative work programs and union resistance to such tactics).

¹⁰⁶ KOCHAN ET AL., *supra* note I, at 15-17.

¹⁰⁷ *Id.* at 19; KOCHAN ET AL., *WORKER PARTICIPATION*, *supra* note 67, at 272-73.

¹⁰⁸ For general discussion of opportunistic conduct by firms using informational advantage, see, e.g., Azariadis & Stiglitz, *supra* note 26, at 12; Robert E. Hall & David M. Lilien, *Efficient Wages Bargains Under Uncertain Supply and Demand*, 69 AM. ECON. REV. 868,

ond factor that increases employees' risk concerns their relative immobility¹⁰⁹ compared to the international mobility of capital.¹¹⁰ Even when a firm has remained in a region for a long period of time, this mobility gives employers a potent bargaining tool.

Also, workers are disadvantaged because employees tend to invest their lives in a corporation and only hold one job.¹¹¹ Thus, although participatory work programs create additional opportunities for each player to attempt to gain at the other's expense, the employees' combined lack of information, risk-aversion, and immobility place them at a distinct disadvantage in playing the productivity game.

2. *The Potential for a Prisoners' Dilemma Solution*

To increase workers' commitment to new shopfloor practices, many firms offer to use their best efforts to prevent layoffs and plant closings.¹¹² However, providing effective assurances of employment stability has become more difficult because the corporate restructuring era has brought about a sudden change in labor relations. Industrial relations experts suggest that opportunistic behavior by some firms in implementing mass layoffs and plant closings has widespread effects. Specifically, this opportunistic behavior has created a "survival of the fittest" atmosphere that causes the labor market as a whole to become less secure.¹¹³ This instability

871 (1979); Bengt Holmstrom, *Equilibrium Long Term Labor Contracts*, 98 Q.J. ECON. 23, 48 (Supp. 1983).

¹⁰⁹ See, e.g., Diane E. Herz, *Worker Displacement in a Period of Rapid Job Expansion: 1983-87*, 113 MONTHLY LAB. REV. 21, 30 (1990) (one out of six displaced workers moved to another city or country to find employment between January 1983 and 1988); Francis W. Horvath, *The Pulse of Economic Change: Displaced Workers of 1981-85*, 110 MONTHLY LAB. REV. 3, 10 (1987) (figures slightly lower than subsequent survey).

¹¹⁰ See, e.g., BARRY BLUESTONE & BENNETT HARRISON, *CAPITAL AND COMMUNITIES: THE CAUSES AND CONSEQUENCES OF PRIVATE DISINVESTMENT* 57 (1980) (stating that the root of the plant closure crisis is the great speed with which capital is moved around the world).

¹¹¹ Clyde Summers states:

If the corporation is conceived in relatively narrow terms as an operating institution combining all factors of production to conduct an ongoing business, then the employees who provide the labor are as much members of that enterprise as the shareholders who provide the capital. Indeed, the employees may have made a much greater investment in the enterprise by their years of service, may have much less ability to withdraw, and may have a greater stake in the future of the enterprise than many of the stockholders.

Clyde W. Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, 4 J. COMP. CORP. L. & SEC. REG. 155, 170 (1982).

¹¹² For a general discussion of the strategies firms use to provide job security, see, e.g., JOCELYN F. GUTCHESS, *EMPLOYMENT SECURITY IN ACTION: STRATEGIES THAT WORK* (1988) (retraining workers, using temporary labor, and allowing older workers to retire).

¹¹³ OSTERMAN, *supra* note 20, at 77-86.

has led to a sense of alienation, distrust, and impermanence in the workplace; even employees who have not directly experienced job loss recognize the potential for exploitation as they watch their friends and family members suffer from the harsh consequences of displacement.¹¹⁴ Translated into the X-inefficiency framework, Leibenstein's analysis suggests that these external shocks to the labor market may lead to lower effort levels in firms throughout the United States. In the future, this problem may become more severe because international competition is likely to cause rapid corporate restructuring to become a permanent feature of the United States' economy.¹¹⁵

Viewed in this light, intensifying global market pressures increase the risk that employees' concerns about employment stability will conflict with managers' efforts to contain costs. Given this country's history of adversarial labor relations and the greater potential for opportunistic conduct under participatory work programs, the stage is set for an atmosphere of conflict and mistrust. Under the prisoners' dilemma analysis both players may adopt strategies that protect their interests in the face of worst case assumptions about the other, leading to mutual withdrawal and reflexive hostility. To illustrate, economic pressures may force managers to reduce working conditions. These actions may result in workers withdrawing their commitment from the workplace in the form of lower effort conventions. In turn, these countermoves "will be hailed by skeptics as evidence of original sin which justified the low-discretion work design in the first place,"¹¹⁶ leading managers to revert to traditional shopfloor practices.

While this is a rather negative scenario, it is unfortunately the path that a very large number of firms may follow because the existing environment may cause the pull toward the prisoners' dilemma solution to be stronger than the pull toward the golden rule solution. Indeed, industrial relations experts caution that the spiral of low trust and high conflict may dominate participatory work programs.¹¹⁷ Robert Reich explains that labor and management are caught in a "vicious circle," because "as the economy continues to decline, Americans grow more cynical about collective endeavor; their consequential retreat into egoism merely accelerates the decline since collaboration is the only way to reverse it."¹¹⁸ In other words, workers and managers are trapped in a prisoners' dilemma

114 *Id.*

115 KOCHAN ET AL., *supra* note 1, at 228.

116 ALAN FOX, BEYOND CONTRACT: WORK, POWER AND TRUST RELATIONS 116-17 (1974).

117 KOCHAN ET AL., *supra* note 1, at 165.

118 REICH, *supra* note 1, at 239.

that makes it difficult for existing facilities in the United States to compete.

The sum of these individually rational actions, however, falls far short of the golden rule solution that could be achieved with trusting collaboration. Participatory programs have the potential to lead to greater X-efficiency because the parties can move in virtuous, as well as vicious, circles. Specifically, workers should be willing to increase firm productivity in return for greater control over the strategic decisions of the corporation and some guarantee of job security.¹¹⁹ The next section explores in detail theories of how players break free of the adversarial cycle that leads to the prisoners' dilemma solution.

C. Solving the Prisoners' Dilemma Presented by Participatory Work Programs

1. *Repeated Play of the Game and the Limits of Economic Theory*

The prisoners' dilemma is a noncooperative game, a game in which the players cannot make credible commitments to cooperate.¹²⁰ Economists suggest, however, that repeated play of a noncooperative game usually produces results similar to those achieved under a cooperative game in which such commitments are possible.¹²¹ Specifically, repetition allows the implicit agreement to refrain from opportunism to become self-enforcing because each player recognizes that the decision to defect in any round of play will trigger a similar response from the other player in the next round.¹²² The combination of the fear of retaliation for defecting and the prospect of future benefits from cooperating may cause the players to reach a mutually beneficial solution. Once the players make the initial move to cooperate, a "lock-in" effect arises that promotes a pattern of collaboration through the game. In the case of participatory work programs, repeated play of the productivity game may lead to the golden rule solution. That is, commitments to attain the golden rule solution would be enforced by the threat that, should the employees defect by reducing their effort levels, the employers would reciprocate in the following round with declining working conditions.

But there is a problem. An "end-game problem" arises that threatens cooperation if the parties know in advance when the rela-

119 See, e.g., Aoki, *supra* note 50, at 47.

120 KREPS, *supra* note 79, at 29.

121 This is the so-called "folk theorem" on noncooperative game theory. See, e.g., ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* 32 (1984).

122 *Id.* (describing this as the "tit-for-tat" strategy); KREPS, *supra* note 79, at 65-71.

tionship will terminate.¹²³ Under these conditions, cooperation is no longer beneficial during the last round of play because there will be no punishment for cheating; thus both players have an incentive to defect during the last round in order to capture the largest payoff. The end-game situation poses a serious problem because each player's strategy for a certain round must be part of optimal strategy for the entire game. If cooperation is not optimal during the last round, then there can be no threat of retaliation on the next to the last round and the parties will have an incentive to defect during the next to the last stage of the game. Continuing this scenario, game theory models predict that cooperation will quickly unravel because it will no longer be optimal on any round of play.

That production may be viewed as a repeated game does not automatically lead to the conclusion that the golden rule solution will occur. Indeed, during periods of economic decline, both workers and managers have incentives to pursue the "end-game" strategy. As the last round approaches, productivity may fall as workers attempt to expropriate capital surplus. High relative wages and low productivity in the American auto and steel industries may be the result of such end-game scenarios.¹²⁴ Managers can also play the end-game because they no longer have the incentive to maintain their reputations for trustworthiness. Thus, managers may seek to renege upon implicit employment agreements by expropriating the workers' share of the firm surplus in the form of deferred compensation and wages.

Economists suggest that cooperation is more likely under repeated games because rational parties learn that cooperative behavior is efficient.¹²⁵ Yet, game theory does not explain why parties choose to cooperate in the first place, what produces the lock-in effect in repeated games, and what prevents the end-game problem. The missing ingredient in game theoretic reasoning concerns "one of the most fragile, yet powerful human dispositions—interpersonal trust."¹²⁶ When parties lack mutual trust, the prisoners' dilemma

¹²³ See KREPS, *supra* note 79, at 66; Richard Selten, *The Chain-Store Paradox*, 9 THEORY & DECISION 127 (1978).

¹²⁴ See Colin Lawrence & Robert Z. Lawrence, *Manufacturing Wage Dispersion: An End Game Interpretation*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY 47, 52 (Brainard & Perry eds., 1985).

¹²⁵ AXELROD, *supra* note 121, at 56.

¹²⁶ Edward H. Lorenz, *Neither Friends Nor Strangers: Informal Networks of Subcontracting in French Industry*, in TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS 201 (Dasputa Gambetta ed., 1988) [hereinafter COOPERATIVE RELATIONS]; see also David M. Kreps et al., *Rational Cooperation in the Finitely Repeated Prisoners' Dilemma*, 27 J. ECON. THEORY 245 (1982) (End game problem will not arise if players are people who on moral grounds would never abuse trust or irrationally follow tit-for-tat strategy.). For criticism of game theory models for avoiding issues concerning trust, see, e.g., AMARTYA SEN, ON

solution occurs because mistrust causes the pull toward adversarial behavior to be stronger than that toward cooperative behavior.¹²⁷ To overcome the prisoners' dilemma, it is necessary to have action that is beyond individual rational choice. In other words, a "group rationality" solution is necessary to reach the golden rule solution.¹²⁸

Surprisingly, social scientists have not devoted much attention to the analysis of trust and distrust in social relationships.¹²⁹ One possible definition of trust is: "action that (1) increases one's vulnerability to another whose behavior is not under one's control, and (2) takes place in a situation where the penalty suffered if the trust is abused would lead one to regret the action."¹³⁰ Emphasizing the emotional aspect of trust, William Bratton asserts that trust involves "a fellow feeling, based on the good will of others."¹³¹ When trust is abused, these "fellow feelings" produce guilt and the risk of social disgrace and condemnation.¹³² Because of these feelings, parties can make credible commitments that they will not engage in future opportunistic conduct.¹³³ Most importantly, parties cannot provide credible commitments to refrain from self-interest unless the feelings of trust and confidence are heartfelt.¹³⁴

Although economists recognize that trust is an efficient mechanism to reduce negotiating and monitoring costs,¹³⁵ it is difficult to

ETHICS AND ECONOMICS (1987); Amartya Sen, *Goals, Commitment, and Identity*, 14 J.L. ECON. & ORG. 341, 342 (1985).

¹²⁷ See, e.g., ROBERT H. FRANK, *PASSIONS WITHIN REASON* 252-53 (1988) (Experiments show people cooperate when they expect others to cooperate; they defect when they expect others to defect.).

¹²⁸ LEIBENSTEIN, *INSIDE THE FIRM*, *supra* note 72, at 74.

¹²⁹ BERNARD BARBER, *THE LOGIC AND LIMITS OF TRUST* 5 (1983); NIKLAS LUHMANN, *TRUST AND POWER* 8 (1979).

¹³⁰ Lorenz, *supra* note 126, at 197; see also Barber, *id.* at 21 ("[T]rust is an integrative mechanism that creates and sustains solidarity in social relationships and systems."); Bruce Chapman, *Trust, Economic Rationality and the Corporate Fiduciary Obligation*, U. TORONTO L.J. (forthcoming 1993) ("Trust means that some individual, somewhere in the economy, must be making a voluntary choice against the alternative which would maximize her preferences or, at least, must be able to get others to believe that she will do just that.").

¹³¹ William W. Bratton, Jr., *Self-Interest and Good Will in Corporate Fiduciary Law* (unpublished manuscript, on file with author).

¹³² See, e.g., LUHMANN, *supra* note 129, at 36.

¹³³ See, e.g., FRANK, *supra* note 127, at 5 ("Being known to experience certain emotions enables us to make commitments that would otherwise not be credible.").

¹³⁴ *Id.*

¹³⁵ See, e.g., KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* 23 (Looking at trust as a commodity, but noting that "[i]f you have to buy it, you already have some doubts about what you've bought."); see also Partha Dasgupta, *Trust as a Commodity*, in *COOPERATIVE RELATIONS*, *supra* note 126, at 53 (Trust reduces negotiation and monitoring costs by protecting expectations in situations that are not covered explicitly in the agreement.); Williamson, *supra* note 19, at 240-41.

discuss this behavior using the language of the self-interested, rational actor paradigm. Technically, economists do not use the term "self-interest" to mean "selfish," rather the term encompasses many values including altruism.¹³⁶ Yet, James Boyd White doubts that this is possible, asserting: "one cannot habitually think of human action in such terms—especially in a culture like our own, which is so heavily dominated by the motive of self-interest in the usual sense, that of selfishness or self-centeredness—without tending to universalize their ordinary rather than their technical meanings."¹³⁷ The language of economics fails to encompass the reality of moral commitments because it has no way of discussing the concept of trust except by treating it as a commodity that can be exchanged.

Discussing trust as a commodity is not only dehumanizing,¹³⁸ it is also self-defeating because genuine trust is not experienced in utilitarian terms.¹³⁹ In other words, the moral person values trust for its own sake, not as a matter of material gain. The language of economics do exemplify certain types of thinking found throughout our culture. In times of economic decline, the moral person who fails to pursue self-interest is simply a "chump."¹⁴⁰ Ironically, the chump's moral sentiments confer material advantages in the long-run because refraining from the short-run pursuit of self-interest al-

¹³⁶ RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 3-4 (4th ed. 1992).

¹³⁷ JAMES B. WHITE, *JUSTICE AS TRANSLATION: AN ESSAY IN CULTURAL AND LEGAL CRITICISM* 55 (1990).

¹³⁸ See, e.g., AMITAI ETZIONI, *THE MORAL DIMENSION—TOWARD A NEW ECONOMICS* 8 (1988) (To economists "a high level of trust reflects not successful socialization but either numerous prior reiterations, small stakes, or high verification costs."); ROBIN MALLOY, *LAW AND ECONOMICS: A COMPARATIVE APPROACH TO THEORY AND PRACTICE* 93 (1990) ("Respect for individual liberty and human dignity require a recognition of the need for moral dialogue separate and apart from the analysis of costs and benefits in a purely neoclassical economic sense."); WHITE, *supra* note 137, at 37 (forms of life presented by economics contain ethical hazards); WILLIAMSON, *CAPITALISM*, *supra* note 8, at 405 n.20 ("The calculative orientation that economists bring to bear advantageously on other matters may be a disability on this. Organization theory specialists, being less committed to the rational spirit, have less baggage to content with."); William Simon, *Social-Republican Property*, 38 *UCLA L. REV.* 1335, 1388-89 (1992) ("Commodification undermines the sense of intrinsic satisfaction in economic activities by eroding the sense of connection between the activity of work and its social meaning and by eroding the experience of work as membership in a community."); Bratton, *supra* note 131 (Descriptions of cooperation based on individual self-interest fail because it is not possible to "eras[e] the ethics of good will from a positive picture that recognizes cooperation as a maximizing instrument."). These limitations of economics may explain why the growth of the law and economics movement in law schools may be slowing down. See, e.g., Robert Ellickson, *Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics*, 65 *CHI.-KENT L. REV.* 23, 23 (1989).

¹³⁹ ALBERT O. HIRSHMAN, *EXIT, VOICE, LOYALTY* 37 (Loyalty is more effective when employees have a strong attachment to a firm that is similar to other firms.); Bratton, *supra* note 131 ("useful ethics are never mere utilitarian instruments").

¹⁴⁰ *Id.* at 249.

lows credible commitments at a lower cost.¹⁴¹ That is, the chump's emotional predisposition allows other parties to confer trust even when the moral person's actions cannot be monitored. Thus, one must come to terms with the factors that conventional economic analysis defines as "extra-economic" by discussing altruistic or "non-opportunistic" motivations for behavior.

2. *Gift Exchanges and Loyalty Filters*

Sociologist George Akerlof incorporates notions of trust and loyalty into the theory of implicit employment arrangements.¹⁴² Akerlof examines a group of employees who produced more than the minimum required by the firm without the expectation of rewards. Other economists account for this behavior by suggesting that employees who enjoy their jobs provide consummate cooperation because they suffer deep regret if they jeopardize their positions by shirking.¹⁴³ Yet, in the case studied by Akerlof, the workers faced only a mild sanction for performance below the minimum. To explain this seemingly irrational behavior, Akerlof presents an alternative model of implicit employment agreements that describes employees and managers in a trading relationship of partial gift exchanges. Under this model, norms of gift exchange develop during the employment relationship whereby the firm relaxes work rules and employees show their appreciation and obligation by providing gifts that consist of diligent work or consummate cooperation.¹⁴⁴ Akerlof suggests that workers receive utility from making gifts to the firm because they acquire sentiment for each other and for the firm.¹⁴⁵

Under this gift-exchange model, moral obligations influence the parties' cost-benefit calculations. Amitai Etzioni explains that moral values "define, often loosely, what is within the range and what is beyond the pale."¹⁴⁶ Social conventions inherent in the employment relationship allow general understandings of acceptable behavior for the gift exchange. Specifically, the reciprocal nature

¹⁴¹ *Id.* at 237.

¹⁴² George A. Akerlof, *Labor Contracts as Partial Gift Exchange*, in EFFICIENCY WAGE MODELS OF THE LABOR MARKET 66 (George Akerlof & Jane Yellen eds., 1986). See generally Kenneth J. Arrow, *Gifts and Exchanges*, 1 PHIL. & PUB. AFF. 343 (1972) (discussing rival use of gift and exchange as a means of allocating resources).

¹⁴³ Jurgen Backhaus, *Workers' Participation Stimulated by the Economic Failure of Traditional Organization: An Analysis of Some Recent Institutional Development*, in CODETERMINATION, *supra* note 32, at 227, 241. Akerlof also notes that conventional economic analysis has difficulty explaining why the workers produced more than required and why the firm did not raise the minimum standard. Akerlof, *supra* note 142, at 66.

¹⁴⁴ *Id.* at 73.

¹⁴⁵ *Id.*

¹⁴⁶ ETZIONI, *supra* note 138, at 75.

gift exchanges suggest that if one party fails to meet the others' expectations, the other party will respond by withholding its gifts.¹⁴⁷ For example, if the firm fires a slow worker, the other workers usually respond by lowering the effort norm as a sanction.¹⁴⁸

Akerlof's model suggests that the gift exchange nature of employment relationships plays a central role in shaping employees' moral commitment to coworkers and the firm, as well as providing them with a sense of fulfillment. In another article, Akerlof introduces the concept of "loyalty filters."¹⁴⁹ He suggests that when people go through experiences, frequently their loyalties and values change.¹⁵⁰ Because parties have a choice over their experiences, they can exercise some choice over their values by actively pursuing certain loyalty filters.¹⁵¹ By using the notion of loyalty filters to explore preferences, one can examine the organizational and cultural devices that make trust possible. This analysis, however, challenges the mainstream economic assumption that preference-shaping processes are exogenous to market transactions.

In sum, gift exchanges and loyalty filters have important consequences for the changing nature of implicit employment agreements under participatory work programs. Specifically, they suggest that extra-economic elements like altruism and loyalty may coincide with greater X-efficiency. The next section explores how firms using participatory shopfloor practices are attempting to provide loyalty filters by developing corporate cultures that seek to foster high-trust

147 See Akerlof, *supra* note 142, at 73.

148 *Id.* at 86.

149 George Akerlof, *Loyalty Filters*, 73 AM. ECON. REV. 54 (1983).

150 Akerlof explains:

The modeling of each of these aspects of reality constitutes a departure of importance from standard economic models, capable of explaining such phenomena as cooperative behavior, class loyalties and much institutional behavior. While the latter allows for the fractional satisfaction of preferences in their changed form, and so appears quite conventional in its continued instrumental approach to individual choice, it is, nevertheless, still a quite unconventional and non-instrumental approach to institutions, or games, in that now these are seen not only as devices through which individuals seek to satisfy given preferences, but also as mechanisms through which their given preferences are changed.

Id. at 62.

151 *Id.* at 56 (teaching children a code to act against their own short-run interest even while it serves their long-run economic interests); see also FRANK, *supra* note 127, at 69 (The commitment model requires "a central role for cultural conditioning in the acquisition of moral sentiments. People may even make rational choices about the sorts of conditioning they expose themselves to."); Jeffrey Nesteruk, *Legal Persons and Moral Worlds: Ethical Choices Within the Corporate Environment*, 29 AM. BUS. L.J. 75, 75 (1991) ("Preferences are never entirely exogenous; the corporate environment affects in significant ways the character of ethical decision-making by individuals within its hierarchy.").

work relations which encourage worker identification with the company and its goals.¹⁵²

3. *The Role of Loyalty Filters in Reshaping Corporate Culture*

This section focuses upon the role of the firm as a social institution to examine how corporate cultures involve unwritten rules of the productivity game that establish norms of behavior for firm members.¹⁵³ By focusing upon these norms, it is possible to see how the policies that underlie shopfloor practices significantly influence the way people perceive both labor relations and corporations. For example, one cannot overstate the effect that the historical separation of "thinkers" from "doers" has had upon our culture.¹⁵⁴ Taylorism reduces the need for firms to rely upon the gift exchange aspect of the employment relationship by using specialized job assignments and heavy monitoring. Consequently, moral commitments to coworkers and firm loyalty are less important for production.

The shift from Taylorism to participatory work programs represents a transition from "low trust" to "high trust" work relations.¹⁵⁵ Under participatory work programs, employers have significant responsibilities; these programs are implemented with the expectation that this high level of trust will be reciprocated by employees on the shopfloor by providing greater effort and creativity. This reliance upon the gift exchange aspect of work relations implies a more general change of customs, attitudes, and values that are part of our cultural heritage. In order to facilitate this gift exchange, firms seek

¹⁵² In a sense, the corporate culture defines well understood rules for the productivity game which economize on bounded rationality. Thus, corporate culture has something of the nature of firm-specific capital. Similarly, firm loyalty, like other firm-specific human capital investments, increase the workers' value to the firm, but are of no particular benefit to other firms. See, e.g., Jacques Cremer, *Common Knowledge and the Co-ordination of Economic Activities*, in TREATIES, *supra* note 38, at 53, 59; see also David Kreps, *Corporate Culture and Economic Theory*, in PERSPECTIVES ON POSITIVE POLITICAL ECONOMY (James Alt & Kenneth Shepsle eds., 1990).

¹⁵³ In contrast to this view of the firm as a social institution, neoclassical economic theory perceives the firm as a series of market-like contracts. Alchian and Demsetz exemplify this view:

To speak of managing, directing, or assigning workers to various tasks is a deceptive way of noting that the employer continually is involved in renegotiation of contracts on terms that must be acceptable to both parties. Telling an employee to type this letter rather than to file that document is like my telling a grocer to sell me this brand of tuna rather than that brand of bread.

Alchian & Demsetz, *supra* note 14, at 777. In my view, the firm represents a social institution involving informal codes of behavior that serve as substitutes for this type of market-like contracting.

¹⁵⁴ See REICH, *supra* note 1, at 173.

¹⁵⁵ Fox, *supra* note 116, at 116-17 (using "high trust jobs" and "low trust jobs" to distinguish work roles).

to change traditional work attitudes by developing environments that are more conducive to higher performance and morale. As a result, participatory work practices have given rise to attempts to promote a shared "culture" or corporate value system.¹⁵⁶ In developing these corporate value systems, firms establish informal moral codes for cooperative behavior that promote group success by encouraging employees to act in the firm's best interests rather than their own.

Because employees and managers have incompatible goals, it would be irrational for either party to exhibit totally trusting attitudes. Yet, the employment relationship is conducive to mutual trust because it is characterized by mutual dependence.¹⁵⁷ A party that is receptive towards a trusting relationship can send signals to the other party that it is safe to develop trust.¹⁵⁸ Once trust is given, it can be maintained by continuously sending signals to foster "systems trust." Under systems trust, people overcome informational barriers by relying instead upon the structural properties of their relationship with the other party.¹⁵⁹

Firms implementing participatory work programs attempt to foster systems trust in two ways. First, many of these firms are moving away from hierarchical enforcement of corporate goals. Hierarchy signals that managers are more important to the firm than workers and that workers cannot be trusted.¹⁶⁰ Consequently, hierarchy creates distance and separation between members at different levels of the organization.¹⁶¹ In contrast, participatory shopfloor practices attempt to nurture the employment relationship by reducing supervision and increasing job satisfaction and employee commitment. Firms use non-authoritarian management styles to create

¹⁵⁶ For a general discussion of different types of corporate cultures see, e.g., TERRENCE E. DEAL & ALLAN A. KENNEDY, *CORPORATE CULTURES: THE RITES AND RITUALS OF CORPORATE LIFE* (1987) (how to create more cooperation culture); WILLIAM G. OUCHI, *THEORY Z* (1987) (corporate culture in Japanese firms); PAUL THOMPSON & DAVID MCHUGH, *WORK ORGANIZATIONS: A CRITICAL INTRODUCTION* (1990) (critical analysis of the merchandising of corporate cultures); WILLIAM H. WHYTE, JR., *THE ORGANIZATION MAN* (1956) (criticizing how the corporate culture shapes the values of middle managers). For the impact that changing corporate cultures has on the new shopfloor practices, see, e.g., Irene Goll, *Environment, Corporate Ideology, and Employee Involvement Programs*, 30 *INDUS. REL. L.J.* 138 (1991) (survey of 159 manufacturing companies concludes that corporate ideology has a significant effect on participative practices in both union and nonunion settings).

¹⁵⁷ LUHMANN, *supra* note 129, at 37.

¹⁵⁸ *Id.* at 28, 37; FRANK, *supra* note 127, at 98, 105.

¹⁵⁹ LUHMANN, *supra* note 129, at 37 (explaining use of systems trust). See generally HIRSHMAN, *supra* note 139, at 79 ("[T]he most loyalist behavior retains an enormous dose of reasoned calculation.").

¹⁶⁰ HECKSCHER, *supra* note 40, at 88.

¹⁶¹ LEIBENSTEIN, *INSIDE THE FIRM*, *supra* note 72, at 101 (Workers cannot "judge how relatively unknown and faceless members of the bureaucracy will react.").

a climate of trust and to encourage employer identification with the company's goals. Second, firms using the new shopfloor practices hold periodic group meetings to promote social and emotional ties among coworkers.¹⁶² These meetings also reinforce the cultural conditioning necessary for employees to internalize the norms and values of the organization.

Efforts to create a more cooperative climate on the shopfloor by reducing monitoring and building team spirit usually have some positive influence upon the workplace atmosphere.¹⁶³ It is unlikely, however, that these attempts to reshape the corporate culture will encourage a great amount of trust.¹⁶⁴ These signals for developing systems trust do not have much credibility because they are inexpensive and easy to fake.¹⁶⁵ Under the new corporate cultures, the most important factors that lead to the low-trust syndrome between managers and workers remain ineffectual. For example, firms send conflicting signals when workers are laid off during the course of a participatory program.¹⁶⁶ Consequently, recent steps taken to promote cooperation do not remove the threat of industrial conflict. Indeed, studies indicate that employee trust and confidence in management practices has declined in the last decade.¹⁶⁷

Although recent attempts to change the corporate culture involve low-risks steps, these efforts are significant because they raise issues concerning the social organization of the corporation and preference-shaping processes, which have not received much attention in the past. Specifically, the focus upon corporate culture raises questions about the gift exchange nature of the employment relationship and how this gift exchange can be supported by providing

¹⁶² See, e.g., FRANK, *supra* note 127, at 239 (“[F]eelings of moral responsibility are much more focused on people with whom we have close personal ties. This suggests that shirking might be attacked by creating a work environment that fosters closer personal ties between coworkers.”).

¹⁶³ See, e.g., KOCHAN ET AL., *supra* note 1, at 87 (short-term effects on changes); THOMPSON & MCHUGH, *supra* note 156, at 234 (“At least some of the hoop-la and contrived events could produce a stream of Hawthorne effects of a short-lived and superficial nature.”); C.A. Roy, *Corporate Culture: The Last Frontier of Control*, 23 J. MGMT. STUD. 287, 292-93 (1986) (“[W]hile bureaucratic control may prompt individuals to act as if the company is a source of meaning and commitment, that is an entirely different matter from seriously believing it.”).

¹⁶⁴ See, e.g., THOMPSON & MCHUGH, *supra* note 156, at 99; Jeremy Brecher, *Uncovering the Hidden History of the American Workplace*, 10 REV. RADICAL POL. ECON. 1, 20 (1978) (New corporate cultures involve “window dressing which leaves untouched the essential tyranny of the capitalist labor process.”).

¹⁶⁵ THOMPSON & MCHUGH, *supra* note 156, at 99.

¹⁶⁶ See, e.g., KOCHAN ET AL., *WORKER PARTICIPATION*, *supra* note 67, at 58-59; Klare, *Debate*, *supra* note 5, at 66-67.

¹⁶⁷ See, e.g., KOCHAN ET AL., *supra* note 1, at 214 (About one-half of the workforce remains skeptical of top management's ability or willingness to address the full range of worker interests or expectations.).

loyalty filters. To attain the golden rule solution it is necessary to take further steps to reshape the corporate culture, steps which accept the differences in organizational goals between employers and workers.¹⁶⁸ Specifically, firms could foster this culture by coordinating labor policies at the shopfloor, collective bargaining, and strategic decisionmaking levels within the corporate structure.¹⁶⁹ The next part explores these issues by analyzing how legal reform mandating codetermination may allow the parties to avoid the prisoners' dilemma problem by altering the rules of the game so that cooperation is easily recognized as a more attractive strategy than defection.

III

X-EFFICIENCY AND CORPORATE GOVERNANCE STRUCTURES

This part analyzes how legal reform that grants employees a role in corporate governance would support the gift exchange of high effort expenditure by workers and working conditions by managers. Part IV of this Article proposes a new model of corporate governance with directors serving as neutral referees to mediate the competing concerns of stockholders and employees. The neutral referee model has many of the goals sought by the German system of codetermination. This part uses the familiar codetermination model to examine how labor representation in corporate governance enables corporate cultures to facilitate participatory work programs. After examining how codetermination enhances X-efficiency, this part provides an efficiency justification for legal intervention to require firms to provide labor representation on corporate boards.

A. X-Efficiency and Worker Representation on Corporate Boards

Under the German system of codetermination, workers elect representatives to serve on supervisory boards of directors that engage in strategic corporate decisionmaking.¹⁷⁰ Codetermination, however, does not directly enable labor to force major changes in

¹⁶⁸ *Id.* at 244; REICH, *supra* note 1, at 268 (Adjustment to economic change requires that burdens and benefits be fairly shared.).

¹⁶⁹ See, e.g., Klare, *Debate, supra* note 5, at 77 ("Progress toward democratizing work requires abandoning the notion of a choice between adversarial and cooperative models and developing instead institutional structures that combine the virtues and mitigate the disadvantages of each.").

¹⁷⁰ For discussion of the German system and developments in the European Community, see, e.g., Alfred F. Conard, *The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law*, 82 MICH. L. REV. 1459 (1984); Clyde W. Summers, *Worker Participation in the U.S. and West Germany: A Comparative Study From an American Perspective*, 28 AM. J. COMP. L. 367 (1980); Detlev F. Vagts, *Reforming the "Modern" Corporation: Perspectives From the German*, 80 HARV. L. REV. 23 (1966).

corporate policy. Rather, most of the employees' influence occurs through separate employee organizations called Works Councils.¹⁷¹ Codetermination enhances the effectiveness of these Works Councils by providing labor representatives with the opportunity to attend board meetings and review firm documents. Employees can gain access to reliable information concerning the firms' financial situation and planned innovations concerning work rules and technological shifts. Although providing workers with representation on corporate boards increases organizational costs, these additional expenses are outweighed by the potential gain of eliminating X-inefficiencies under the traditional system of corporate governance.

Under the traditional system, employee distrust arises because managers have an informational advantage and nonlegal enforcement mechanisms are inadequate to prevent the expropriation of human capital investments.¹⁷² For these reasons, employees resist technological advances and new shopfloor practices by insisting upon contractual work rules that limit and delay such innovations.¹⁷³ Conversely, codetermination facilitates the flow of credible information to employees. Employees are less skeptical about management's assessment of the firm's economic condition because they have access to the information needed to make their own evaluation.¹⁷⁴ By enhancing workers' ability to monitor the firms' performance, codetermination restrains opportunistic conduct by firms. Specifically, if managers renege upon implicit employment arrangements, employees can hold them accountable in future interactions by withdrawing cooperation and reducing effort norms.¹⁷⁵ In this way, codetermination provides incentives for employees to invest in firm-specific skills by protecting these investments from expropriation.¹⁷⁶

¹⁷¹ See, e.g., Roy Adams, *Workers' Participation in Management in West Germany: Impact on the Worker, the Enterprise and the Trade Union*, 8 INDUS. REL. L.J. 4 (1977); Clyde W. Summers, *An American Perspective of the German Model of Worker Participation*, COMP. LAB. L.J. 333 (1987).

¹⁷² See *supra* notes 104-05 and accompanying text.

¹⁷³ See *supra* notes 104-06 and accompanying text.

¹⁷⁴ See, e.g., Jurgen Backhaus, *Workers' Participation Stimulated by the Economic Failure of Traditional Organization: An Analysis of Some Recent Institutional Developments*, in CODETERMINATION, *supra* note 32, at 227, 232; Eirik G. Furubotn & Steven N. Wiggins, *Plant Closings, Worker Reallocation Costs and Efficiency Gains to Labor Representation on Board of Directors*, 140 J. INST. AND THEORETICAL ECON. 176 (1984).

¹⁷⁵ See Roger McCain, *A Theory of Codetermination*, 40 J. ECON. 65, 83 (1980) (arguing that strategic information offers the employees a "more valuable hostage" in future negotiations with managers).

¹⁷⁶ See, e.g., Eger & Weise, *supra* note 32, at 64. Codetermination also enhances the internal efficiency of firm operations because workers are in many respects better positioned to monitor a firm's management than shareholders. Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749, 1768 (1990). Other commentators cast doubt upon the idea that work-

By reducing the employees' risk of opportunism, codetermination provides a commitment structure that supports the process of building high trust relations between managers and workers.¹⁷⁷ Cooperative behavior depends upon the willingness of one player to make the initial move to cooperate, which risks exploitation by the other player.¹⁷⁸ Under codetermination, firms make this type of cooperative move by relinquishing an informational advantage. At the same time, however, this move increases the firm's vulnerability to opportunism by employees. Yet, this loss of control is exactly the type of necessary risk-exposing action that plays an important role in promoting the lock-in effect which establishes patterns of collaborative conduct.¹⁷⁹ Viewed in this light, codetermination involves a high-risk step that sends a strong signal of managerial trustworthiness and dedication to a more cooperative regime in volatile economic conditions.

By sending this signal to support the process of building trust, codetermination establishes the basis for a corporate culture that elicits high commitment performance. Under this culture, workers may feel a moral obligation to reciprocate managers' trust by establishing higher effort levels, setting in motion a cycle of cooperative efforts on the shopfloor.¹⁸⁰ For example, employees may have greater enthusiasm for new production methods because they have some information to ensure that they will realize the benefits from these innovations.¹⁸¹ In addition, communication throughout the

ers have the proper incentives to enhance the internal efficiency of the firm. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. ECON. 395, 403-06 (1983) (Workers lack incentives to exercise correct discretion in choosing among investment projects.); Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination*, 52 J. BUS. 469, 482-84 (1979) (Because horizon is limited to working life, investment decisions favor of quick payoff.).

¹⁷⁷ Marvin E. Rozen, *X-Efficiency, Implicit Contracting, and the Theory of the Firm*, in STUDIES IN ECONOMIC RATIONALITY: X-EFFICIENCY EXAMINED AND EXTOLLED 95, 115 n.15 (1990) (Klaus Weiermair & Mark Perlman eds., 1990) ("Substantive parity between the parties, or at least the absence of great disparities, in the relevant dimensions of economic strength is likely to be a prerequisite for trust to bloom. Dependency, because it implies one-way flows, corrodes trust."). Alan Hyde and Robert Reich propose the use of employee stock option plans (ESOPs) to remedy problems of low employee trust. ROBERT REICH, *TALES OF NEW AMERICA* (1987); Hyde, *supra* note 80.

¹⁷⁸ AXELROD, *supra* note 121, at 113-15.

¹⁷⁹ LUHMANN, *supra* note 129, at 55 (This enhanced communication allows "the person who gives his trust [to be] in possession of enough reality to be able occasionally to opt out of using them.").

¹⁸⁰ See, e.g., KOCHAN ET AL., *supra* note 1, at 116 (providing strategic information to employees will contribute to gains on the shopfloor); Furubotn & Wiggins, *supra* note 174, at 64. See generally LORENZ, *supra* note 126, at 53 (stating that when trust is created, obligated not to betray trust).

¹⁸¹ See, e.g., Eirik Furubotn, *Codetermination, Productivity Gains and the Economics of the Firm*, 37 OXFORD ECON. PAPERS 22, 27 (1985) (codetermination improves information

firm may be enhanced as employees respond by relinquishing their informational advantage concerning knowledge about more efficient processes and work rules on the shopfloor. Furthermore, workers may be more willing to accept lower working conditions in times of financial difficulty because they will have more confidence that they will gain from these sacrifices in the long-run. Accordingly, through repeated play of the game, managers can obtain some assurance that employees aspire to provide consummate cooperation for participatory work programs.¹⁸²

Supporting this view, economist Masahiko Aoki emphasizes that firms acquire market flexibility by providing labor with representation on corporate boards. For example, German and Japanese corporations appear to be more X-efficient than firms in the United States. Aoki asserts that these productivity differences are partly explained by more employee participation in corporate governance.¹⁸³

Of course, codetermination does not automatically produce greater X-efficiency by offering an easy solution to the prisoners' dilemma problem created in participatory work programs. It does, however, facilitate the resolution of this dilemma by increasing the flow of information within the firms and thereby providing greater opportunities for effective communication between labor and management.¹⁸⁴ Although repeated play of the productivity game may also lead to labor-management cooperation under the traditional system of corporate governance, codetermination is more favorable to such an outcome because it removes informational barriers that increase the potential for the prisoners' dilemma solution.

Given these possible increases in X-efficiency, it is necessary to address the need for legal intervention to require labor representa-

flows between managers and workers); McCain, *supra* note 175, at 83-84 (Transition from collective bargaining to codetermination reduces the number of employees' "free variables" concerning work effort.); see also Roger McCain, *Increasing 'Alienation:' The Working Environment and the Direction of Technical Progress Under Alternative Forms of Enterprise Organization*, 3 *ADVANCES IN THE ECON. ANALYSIS OF PARTICIPATORY AND LABOR MANAGED FIRMS* 83, 101 (1988) (same) [hereinafter McCain, *Alienation*]; KOCHAN ET AL., *supra* note 1, at 111 (Prior consultation and participation increases employees commitment to changes in production methods and willingness to reveal production inefficiencies.).

¹⁸² MASAHIKO AOKI, *INFORMATION, INCENTIVES, AND BARGAINING IN THE JAPANESE ECONOMY* 154 (1988); Roger McCain, *Codetermination, Collective Bargaining, Commitment, and Sequential Games*, in *CODETERMINATION*, *supra* note 32, at 115.

¹⁸³ Aoki, *supra* note 38, at 124 ("[T]he impression gained by observing the divergent performances of firms having different national-institutional structures is that the relative magnitude of institutional inefficiency may be substantial."); Aoki, *supra* note 50, at 24 (Despite cultural and historical differences, there is a world-wide tendency to recognize employees' voice in corporate governance.).

¹⁸⁴ Eger & Weise, *supra* note 32, at 28; McCain, *Alienation*, *supra* note 181, at 104; Warren J. Samuels, *Institutional Reform: The Future of Codetermination: Comment*, in *CODETERMINATION*, *supra* note 32, at 223, 225.

tion on corporate boards. In addressing this issue, the next section explores several ways in which the existing sociopolitical system impedes the incentives for firms to adopt codetermination on a voluntary basis.

B. The Need for a Legal Solution to Solve the Prisoners' Dilemma

1. *Legal Intervention to Redistribute Power*

a. *Firms Have a "First Mover Advantage" Under the Existing Rules of the Game*

Corporate law should mandate codetermination because, in the absence of crisis in situations, managers and shareholders tend to resist employee participation in strategic decisionmaking. Under the existing framework for collective bargaining, management has no legal duty to negotiate with unions about economic restructuring, technological innovation, and job security.¹⁸⁵ Unions have difficulty in bargaining for explicit contractual protections on these issues because management often insists on "managerial prerogative" clauses in order to maintain control over the firm's operations.¹⁸⁶

Because codetermination involves sharing control with employees, this redistribution of power ensures that managers and shareholders will oppose proposals for worker representation on the

¹⁸⁵ See *First Nat'l Maintenance Corp. v. NLRB*, 452 U.S. 666, 681-86 (1981) (Section 8(d) does not apply to 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 JIM ATLESON, *VALUES AND ASSUMPTIONS IN AMERICAN LABOR LAW* (1983) (One of the dominant social values in the interpretation and evolution of labor law is that workers do not have the ability to make strategic decisions.).

¹⁸⁶ See, e.g., Staughton Lynd, *Investment Decisions and the Quid Pro Quo Myth*, 29 CASE W. RES. L. REV. 396, 410 (1979) ("[L]abor relinquishes its most effective weapon against management—its ability to strike . . . [while] management retains the prerogative to disrupt the lives of its employees by relocating or closing its facilities."). Existing interpretations of the National Labor Relations Act (NLRA) draw a line between the extent of bargaining and the scope of unilateral decisionmaking referred to as the management prerogative. Employers must bargain over whether to relocate a plant only if the managers' determination is prompted by the need to reduce labor costs. Decisions based on general economic conditions are not subject to mandatory bargaining. Although the NLRA does not provide much relief, presumably, unions would attempt to negotiate for explicit contractual protections against layoffs and plant closings. If managers were willing to negotiate over these issues, employees could attempt to bargain for tin parachutes that provide sufficient amounts of severance pay to compensate employees for their firm-specific investments. However, several contracting obstacles would arise. The parties would have difficulty in specifying the events that would trigger the tin parachute. Additionally, enforcement problems exist because the labor law successorship rules do not bind a purchaser of assets to a previous collective bargaining agreement. Professor Stone explains in more detail the problems in drafting enforceable, effective tin parachutes. Stone, *supra* note 82, at 63-64.

corporate boards. Managers recognize that giving up managerial prerogatives improves the bargaining position of labor, thereby increasing the risk of opportunism. In game theory terms, the existing labor laws allow managers to have a "first mover" advantage in the productivity game.¹⁸⁷ The prisoners' dilemma suggests that first mover advantages increase the potential for X-inefficiency because managers probably will act "rationally" and refuse to share decisionmaking with employees, even though cooperation offers larger returns.¹⁸⁸

b. *A Response to Free Market Arguments Against Legal Intervention to Redistribute Power*

Free market advocates argue that legal intervention is not needed to redistribute control within the firm because in the long run, competition ensures that internally efficient results dominate.¹⁸⁹ Under competitive conditions, only the most cost-effective governance structures will survive. Accordingly, free market proponents suggest that labor representation on the board is less efficient, because otherwise it would replace the traditional system in the free market.¹⁹⁰ Williamson emphasizes that parties have incentives to adopt governance mechanisms that mitigate the threat of opportunism.¹⁹¹ Thus, firms using participatory shopfloor practices have the incentive to implement codetermination in order to reduce the wages necessary to compensate workers for the risks of opportunism.

Free market advocates assert that government has little power over impersonal market pressures that cause corporate restructuring. They warn that regulation of economic forces will ultimately harm employees by decreasing investment incentives. Furthermore, free market advocates argue that attempts to change the law will end up hurting employees because employers will force them to pay for these rights through lower wages.¹⁹² These definitive accounts of

187 Ekkehart Schlicht, *Codetermination, Collective Bargaining, Commitment, and Sequential Games: Comment*, in *CODETERMINATION*, *supra* note 32, at 129.

188 *Id.*

189 WILLIAMSON, *supra* note 7, at 39 n.22.

190 *Id.* at 33; Alchian & Demsetz, *supra* note 14, at 787; Jensen & Meckling, *supra* note 11, at 473.

191 WILLIAMSON, *supra* note 7, at 373; Daniel Fischel, *Labor Markets and Labor Law Compared with Capital Markets and Corporate Law*, 51 U. CHI. L. REV. 1067, 1073 (1984) (Firms would voluntarily deal with unions in order to reduce their cost of labor just as they voluntarily have their financial statements audited in order to reduce their cost of capital.).

192 The law allows firms to externalize the cost of providing for displaced workers by imposing this cost on the public sector. Corporate restructuring may result in long-term benefits for the economy. These new opportunities, however, fail to assure that workers faced with job displacement are compensated for their investments in the corporation.

the inevitability of plant closure and the futility of regulation lead to the conclusion that no alternative exists to the free market.

In this way, free market analysis serves to acclimatize labor to the existing legal framework. Williamson provides a striking example of the free marketers' propensity to reaffirm the status quo when he argues that workers prefer participatory methods of shopfloor organization and corporate governance systems over the traditional methods. Because Williamson maintains that participatory programs are less efficient, he suggests that workers in these firms will receive lower wages.¹⁹³ Next, Williamson states that workers "reveal their preferences" when they chose Tayloristic practices and high wages over employment offering higher job satisfaction but lower wages.¹⁹⁴ Similarly, Williamson asserts that workers "reveal their preferences" for traditional corporate governance systems when they chose conventional employment over opportunities to work for firms with alternative structures that offer participation in governance, such as worker cooperatives.¹⁹⁵

Studies show that workers prefer higher wages over better working conditions.¹⁹⁶ Yet participatory work programs may substantially increase the X-efficiency of the firm, allowing workers to obtain both higher wages and better working conditions. To achieve this result, however, labor participation in corporate governance structures needs to support these programs in order to foster an atmosphere conducive to a high level of employee trust.

Traditionally, employees have not participated in strategic corporate decisionmaking.¹⁹⁷ This historical pattern, however, is changing. The major impetus for change is growing employer

Free market proponents argue that workers who are not hired at new plants lose as much as workers gain at the plant that is not closed. Macey, *supra* note 103, at 179. This article disagrees. People feel the loss of a "psychologically vested right of a given market value more keenly than the loss of a prospect (a psychologically unvested right) of identical market value." Ellickson, *supra* note 138, at 37 (discussing Tversky Kahneman analysis). This argument draws upon the personhood theory of property rights and posits that a worker develops an attachment to his job which is critical to his personal identity. As Holmes stated: "[T]he true explanation of title by prescription seems to me to be that man, like a tree in the cleft of a rock, gradually shapes his roots to his surroundings, and when the roots have grown to a certain size, cannot be displaced without cutting at his life." Oliver W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 477 (1897); see also POSNER, *supra* note 136, at 79 ("Over time a person becomes attached to property that he regards as his own, and the deprivation of the property would be wrenching.").

¹⁹³ Williamson, *supra* note 28, at 34-35.

¹⁹⁴ *Id.*

¹⁹⁵ Jensen & Meckling, *supra* note 11, at 472 (suggesting demands for democratization of the workplace arise more from political activists than from the workforce).

¹⁹⁶ PAUL WEILER, *GOVERNING THE WORKPLACE* 177 n.93 (1990) (discussing studies concluding that workers rank pay higher than job satisfaction).

¹⁹⁷ KOCHAN ET AL., *supra* note 1, at 181. Karl Klare explains:

awareness that important decisions lie beyond the scope of collective bargaining.¹⁹⁸ Increasingly, employees consider exchanging wage increases for greater employment security and more influence in decisionmaking.¹⁹⁹ These developments have been concentrated in crisis situations that threaten layoffs and plant closings.²⁰⁰ These changes still represent fundamental departures from the traditional system of labor relations. Industrial relations experts suggest that employee interest in corporate governance will grow as global market pressures continue to require strategic decisionmaking that adversely impacts the employees' welfare.²⁰¹

Free market proponents' references to the immutable laws of economics attempt to depoliticize social issues concerning displaced workers and industrial democracy. Such legitimating theories obscure the choices involved in enhancing employee participation in corporate decisionmaking, which affects job security and working conditions. In contrast, this Article contends that these choices have significant implications for the efficiency of corporate behavior in responding to international competition. In examining the need for legal intervention, the next section explores how the sociopolitical system in the United States discourages firms from relinquishing their first mover advantages concerning managerial prerogatives.

2. *Participatory Work Programs and Socioeconomic Development*

a. *Free Rider Problems Impede Incentives to Change Conventions Governing Industrial Relations*

Cultural norms, conventions, and institutions increase the transaction costs involved in introducing codetermination through the contracting process. Given the long-standing convention of shareholder supremacy and resistance to employee involvement in strategic decisionmaking, firms are reluctant to deviate from the traditional system of corporate governance because they fear reputational sanctions for violating established business practices.

[I]f the legal system has historically been heavily biased in favor of hierarchy and against participation, the alleged employee preference of hierarchy may be "adaptive." If so, the efficiency attack on legal reform aimed to increase participation is circular reasoning. Legal reforms of the sort proposed here might enhance efficiency by removing the endogenous conditioning of employee preferences.

Klare, *Agenda*, *supra* note 5, at 35.

¹⁹⁸ See, e.g., Thomas A. Kochan et al., *Strategic Choice and Industrial Relations Theory*, 23 *INDUS. REL. J.* 16 (1984).

¹⁹⁹ See, e.g., DOERINGER, *supra* note 1, at 133; KOCHAN ET AL., *supra* note 1, at 112.

²⁰⁰ See, e.g., KOCHAN ET AL., *supra* note 1, at 112 (Airline carriers near bankruptcy, not able to offer employment guarantees, are much more likely to grant unions a broadened role in management affairs.).

²⁰¹ *Id.* at 220.

Given these reputational sanctions, free rider problems prevent firms from undertaking the steps necessary to transform the existing customs to favor more progressive labor policies.

In changing conventions, game theoretic reasoning suggests that an individual firm will not necessarily move to the superior option of using codetermination, since it is not a superior option unless other firms also move and thereby alter widely accepted notions of proper labor-management relations.²⁰² But other firms will not move unless each firm can be persuaded that all the other firms will also move simultaneously. In addition to these free rider problems, each firm has an additional incentive to "hang back" because the current restructuring era creates strong competitive pressures for each firm to forgo the organizational costs in establishing codetermination in order to maintain short-term stock prices. Thus, firms are unwilling to adopt codetermination because it involves the creation of industrial relations that transcend the narrow contracting process. Consequently, public policy sets the climate for labor-management relations by legitimating specific models of corporate governance and affecting the costs associated with alternative practices.²⁰³

b. *Cultural Support for Participatory Work Programs*

The existing legal system not only promotes cultural conditioning that inhibits incentives to provide codetermination, it also perpetuates the tendency for opportunistic behavior that leads to adversarial labor relations. Under existing social and market norms, firms that breach implicit employment arrangements face reputational sanctions in the labor market. These extralegal sanctions, however, lose their effectiveness because the law condones the Darwinian process of "Creative Destruction." By failing to mitigate these destructive impulses, the law represses the expression of altruism, erodes the sense of community in the firm, and sanctions the expropriation of workers' firm-specific investments. In times of economic decline, the law promotes widespread instability in the labor market that impedes efforts to nurture the gift-exchange necessary for the success of participatory work programs.

Williamson acknowledges that the sociopolitical system negatively influences the cooperative attitudes required for participatory

²⁰² LEIBENSTEIN, *INSIDE THE FIRM*, *supra* note 72, at 74.

²⁰³ See, e.g., Thomas A. Kochan & Michael J. Piore, *Will the New Industrial Relations Last? Implications for the American Labor Movement*, *ANNALS*, May 1984, at 473 ("These changes at the micro level of industrial relations are likely to be successful only if macroeconomic policies are reformed to provide a more supportive role for the labor movement in society.").

work programs.²⁰⁴ Specifically, he doubts that participatory work programs will be successful in the United States because these programs depend upon a system of relational contracting to prevent opportunistic conduct.²⁰⁵ Williamson explains:

The 'special problems' of soft contracting . . . are particularly great when soft contracting is introduced into an alien culture. The reason for this is that the entire burden of providing contractual safeguards falls entirely on the immediate parties to the transaction if background cultural supports are missing. Should one of the parties choose to defect, there is no further support for sustaining the transaction to which either can appeal.²⁰⁶

Because participatory work programs depend on the background culture to provide reputational sanctions,²⁰⁷ Williamson suggests that participatory programs may be more viable in countries like Japan rather than the U.S. For these reasons, Williamson asserts that the United States may have to employ the traditional model of work organization.²⁰⁸

Williamson raises important issues by emphasizing how societal and corporate cultures interact. However, he fails to recognize that the law significantly affects industrial relations by influencing conventions of economic behavior that develop within firms.²⁰⁹ Legal reform is necessary to provide employees with a role in corporate governance to create the atmosphere of trust needed to overcome the prisoners' dilemma problems inherent in participatory work programs. Supporting this view, industrial relations experts suggest that because German and Japanese corporations traditionally depended upon foreign trade, the frequent need to adjust to external

204 WILLIAMSON, CAPITALISM, *supra* note 8, at 39 n.22.

205 Oliver Williamson & W. G. Ouchi, *The Markets and Hierarchies Programme of Research: Origins, Implications, Prospects*, in POWER, EFFICIENCY AND INSTITUTIONS 26-28 (Arthur Francis et al. eds., 1983).

206 *Id.* at 28; see also LEIBENSTEIN, INSIDE THE FIRM, *supra* note 72, at 54 ("Western culture does not emphasize altruistically cooperative behavior for its own sake It appears more natural to try to be a big winner by performing according to a win/lose strategy rather than by adhering to an extremely cooperative convention.").

207 *Id.* at 27.

208 WILLIAMSON, CAPITALISM, *supra* note 8, at 28. Similarly, John Macey asserts: [A] Japanese-style employment regime in which workers have job tenure and employers have de facto assurances from workers that they will not leave for other jobs in fact may be more efficient. But in this country workers and their employees are not able to make employment contracts containing these provisions because they would not be enforceable in U.S. courts. Consequently, the dominant American regime of employment at will may be the market's second-best solution in the face of this legal impediment to the contracting process.

Jonathan Macey, *Firm-Specific Human Capital Investments and Hegelian Ethics: A Comment on Cornell and Posner*, 11 CARDOZO L. REV. 505, 507 (1990).

209 See, e.g., KOCHAN ET AL., *supra* note 1, at 230; LEIBENSTEIN, INSIDE THE FIRM, *supra* note 72, at 53 (law supports conventions inside firm).

and internal labor dislocations prompted early cooperation between government, labor, and business to cope with the problems of displaced workers.²¹⁰ Recognizing these historical influences, Robert Reich suggests that: “[a]daptation [to the new realities of international competition] will require that American institutions, both public and private, support the social changes that must accompany economic change. And for this to occur, America must transcend the peculiar distinction traditionally drawn between our civic culture and our business culture.”²¹¹

IV THE NEUTRAL REFEREE MODEL OF CORPORATE GOVERNANCE

In this part, I will propose a new model of corporate governance that would broaden directorial fiduciary duties to encompass employees as members of the firm. First, I will explore how recent developments in the areas of corporate law and labor law show some signs of change in this direction. Next, I will discuss how corporate fiduciary law could be revised to protect employees from opportunistic conduct and promote corporate cultures that foster mutual trust between managers and employees.

A. Redefining Corporate Law and Labor Law: Reflecting the Employees' Changing Role in the Corporate Structure

In the past, the dominant role of collective bargaining in labor law and the prevailing paradigm of shareholder supremacy in corporate law have created intellectual barriers to consideration of viable corporate schemes to promote labor-management cooperation. These underlying assumptions, however, are being challenged as both labor law and corporate law undergo a process of transformation that reflects the changing nature of the employees' role in the corporate structure. At the shopfloor level, there is a growing interest in amending the National Labor Relations Act (NLRA),²¹² in removing barriers that prevent firms from establishing employee committees, and in discussing issues that traditionally have been reserved for union representation. At the board level, directorial fiduciary duties have been revised to allow greater discretion to consider employee interests in making strategic decisions. Although these

²¹⁰ REICH, *supra* note 1, at 10.

²¹¹ *Id.* at 6; *see also* Joseph Singer, *Stakeholders*, U. TORONTO L.J. (forthcoming 1993) (We “face a quasi-constitutional problem about the forms of social life we want to adopt.”).

²¹² 29 U.S.C. §§ 141-187 (1988).

changes are significant, these developments are inadequate to meet the needs of the modern workplace.

1. *Participatory Work Programs: Challenging the Framework of the NLRA*

Given that less than seventeen percent of the workforce is unionized,²¹³ the existing system of labor law that emphasizes collective bargaining simply does not describe the realities of contemporary American labor relations.²¹⁴ For this reason, many labor scholars maintain that a need exists for employees to have the opportunity to participate in alternative mechanisms of workplace governance that would complement the present system of union representation. A foundation to establish such institutions can be seen in efforts by many corporations to implement employee involvement committees that oversee the policy decisions involved in participatory work programs.²¹⁵ At this point, however, these efforts appear to conflict with the NLRA in two respects.²¹⁶

First, some types of participatory work programs may violate the prohibition against company involvement in labor organizations.²¹⁷ Under the NLRA, the framework for collective bargaining

²¹³ See, e.g., Paul Weiler, *Promises to Keep: Securing Workers's Rights to Self-Organization Under the NLRA*, 96 HARV. L. REV. 1769, 1778-81 (1983) (describing decline of unionism and growing anti-unionism in business community).

²¹⁴ Clyde Summers, *Labor Law As the Century Turns: A Changing of the Guard*, 67 NEB. L. REV. 7, 10 (1988) ("The consequence is foreseeable, if not inevitable; if collective bargaining does not protect the [weaker party], the law, . . . either through the courts or the legislatures, will become the guardian. Labor law is now in the midst of that changing of the guard.") [hereinafter Summers, *Labor Law*]; Clyde Summers, *Past Premises, Present Failures, and Future Needs in Labor Legislation*, 31 BUFF. L. REV. 9, 17 (1982) [hereinafter Summers, *Past Premises*].

²¹⁵ Summers, *Past Premises*, *supra* note 214.

²¹⁶ For an extended discussion of this issue, see Stephen Schlossberg & Steven M. Fetter, *U.S. Labor Law and the Future of Labor-Management Cooperation*, 37 LAB. L.J. 595 (1986).

²¹⁷ Section 8(a)(2) makes it unlawful for an employer to "dominate or interfere with the formation or administration of any labor organization or contribute financial or other support to it. . . ." National Labor Relations Act, § 8(a)(2), 29 U.S.C. § 158(a)(2) (1988). In Section 2(5), Congress provided a broad definition of the term "labor organization," to include "any organization of any kind, or any agency or employee representation committee or plan" that deals with management concerning "grievances, labor disputes, wages, rates of pay, hours of employment, or conditions of work." National Labor Relations Act, 29 U.S.C. § 152(5) (1988). An employee committee is not illegal if it only exists for the purpose of providing a means of communication between the representatives and the employees. Such a committee becomes a labor organization under Section 2(5) when the employee members communicate in a representative capacity regarding mandatory bargaining subjects such as grievances and working conditions.

The legality of using employee involvement committees in a non-union setting is currently being reviewed by the National Labor Relations Board in *Electromotion, Inc.*, 309 N.L.R.B. No. 163 (1992). In this case, *Electromotion* (the "Company"), set up Action Committees to address serious morale problems arising from the Company's deci-

is based upon adversarial procedures and relationships. In order for unions to effectively advance their interests, the NLRA seeks to secure the union's independence by prohibiting actions that could result in managerial domination of the union. Section 8(a)(2) prohibits employers from supporting or assisting organizations that represent workers in discussions over wages, hours, and working conditions.²¹⁸ Firms that establish committees to oversee participatory work programs may violate this prohibition.

Second, uncertainty also exists for unionized workers involved in participatory work programs because the NLRA limits the right to form unions to employees that lack supervisory duties.²¹⁹ The NLRA draws a clear line between "workers" and "supervisors" that parallels Taylorism's basic separation of "thinkers" from "doers." The new shopfloor practices, however, blur this distinction by allowing workers to make supervisory decisions regarding discipline, job assignments, and hiring. Because the NLRA excludes employees who perform a discretionary managerial function from union representation, unionized workers fear that they may lose their right

sions to change its attendance policy and not give pay increases. The employer selected Action Committee members from a list of employees who volunteered to participate by investigating facts, generating ideas, and providing input to management in an advisory capacity. Management requested that Committee members discuss the issues with their co-workers; thus, the Action Committee members were expected to serve in a representative capacity.

The NLRB administrative law judge found that the Action Committees were labor organizations and that Company had unlawfully dominated these Committees. The Company appealed to the National Labor Relations Board. The National Labor Relations Board asked the parties to specifically address two issues:

- (i) At what point does an employee committee lose its protection as a communication device and become a labor organization?
- (ii) What conduct of an employer constitutes domination or interference with the employee committee?

For an overview of this case, see, e.g., Madelyn Carol Squire, *Reality or Myth: Participatory Programs and Workplace Democracy*, STETSON L. REV. (forthcoming 1993). By raising these issues, the Board appeared to be on the verge of formulating a new age of cooperation in the workplace. Yet many commentators agree that given the facts of the case, the Board had little choice in finding that the Action Committees constituted a labor organization within the meaning of section 2(5) and that Electromation's conduct constituted domination in violation of section 8(a)(2).

²¹⁸ In *NLRB v. Cabot Carbon Co.*, 360 U.S. 203, 213 (1959), the Supreme Court held that an employee group "dealing with" issues under the NLRA constitutes a "labor organization" under 8(a)(2). There has been a growing trend to retreat from the *Cabot Carbon* decision. See, e.g., *NLRB v. Streamway Div. of the Scott & Fetzer Co.*, 691 F.2d 288 (6th Cir. 1982) (Committee of workers and managers discussing working conditions did not constitute "labor organization."); *General Foods Corp.*, 231 N.L.R.B. 1232, 1234 (1977).

²¹⁹ 29 U.S.C. § 152(3) (1988) (defining "employee"); 29 U.S.C. § 152(2) (1988) (defining "employer"); 29 U.S.C. § (11) (1988) (defining "supervisor"). See *NLRB v. Yeshiva University*, 444 U.S. 672 (1980) (University professors with great discretion over administrative issues cannot unionize.).

to collective bargaining protection if they participate in the firm's employee involvement programs.²²⁰

For these reasons, the NLRA should be revised to accommodate the growing use of employee involvement committees.²²¹ Labor law scholars assert that Section 8(a)(2) should be repealed to allow firms to develop programs that permit employees to voice their concerns about the workplace environment and production methods. In addition, the NLRA should be amended so that unionized employees can retain their right to participate in collective bargaining.

Although the trend toward employee committees indicates greater receptivity to employee involvement in workplace governance, these efforts do not provide the worker representation and collaboration necessary for the success of participatory work programs. First, the continued operation of these programs typically depends upon the unilateral discretion of management; thus, they involve a low-risk step that may easily be reversed. Second, managers usually do not relinquish their informational advantage regarding the firm's financial situation and planned innovations. In order to promote the high level of worker trust required to attain greater X-efficiency, legal reform is required to compel firms to provide access to information that allows workers to supervise management and analyze strategic policies. Paul Weiler proposes legislation along these lines that would establish elected Employee Participation Committees modeled after German Works Councils.²²² He suggests that German Works Councils have successfully responded to many of the same issues concerning economic and industrial change that affect the American workplace.²²³ Under Weiler's proposal, however, the Employee Participation Committees would not

²²⁰ See, e.g., Charles Craver, *The Vitality of the American Labor Movement in the Twenty-first Century*, 1983 U. ILL. L. REV. 633, 644; William Gould, *Reflections on Workers' Participation, Influence, and Power Sharing: The Future of Industrial Relations*, 58 U. CIN. L. REV. 381, 383-84 (1989); Thomas C. Kohler, *Models of Worker Participation: The Uncertain Significance of Section 8(a)(2)*, 27 B.C. L. REV. 499 (1988). So far, the *Yeshiva* case has not been widely used to deny employees the right to unionize. See, e.g., Anamag, 284 N.L.R.B. 621 (1987) (team leaders still employees under NLRA).

²²¹ See, e.g., WEILER, *supra* note 196, at 34.

²²² Paul Weiler advocates the adoption of employee participation committees by firms that employ more than twenty-five workers. *Id.* at 88 (recognizing necessity to "satisfy the need for meaningful protection and participation in the workplace, rather than simply to preserve the institutional formats through which those functions have traditionally been performed"). Some labor scholars such as Karl Klare and Katherine Stone assert that union presence is necessary to ensure that cooperative programs do not coopt workers. Klare, *Debate, supra* note 5, at 68; Stone, *supra* note 18, at 169-71.

²²³ Stone, *supra* note 18, at 172.

provide workers with a role in board decisionmaking and the ability to challenge firm policies in a binding way as they do in Germany.²²⁴

In contrast, this Article maintains that judicial recourse is necessary for Employee Participation Committees to protect workers from opportunistic conduct. This reform would allow employees to sue for breach of directorial fiduciary duties. Although recognizing directorial fiduciary duties to employees would represent a substantial shift in the law, recent developments in corporate law demonstrate that some precedent exists to support this obligation.

2. *The Legal Model of the Corporation: Movements Away From Shareholder Supremacy*

In the past, shareholder supremacy defined the boundaries within which most of the debate about corporate governance occurred. The takeover era, however, highlighted the fundamental conflict between the interests of shareholders and the concerns of other constituents who rely upon the corporation for their well-being. Courts and legislatures responded to the consequent social costs by granting directors discretion to consider nonshareholder constituents in making strategic decisions.²²⁵ These developments aid directors in preventing changes in control that offer shareholders large premiums, but threaten the nonshareholders' investments in the firm.

This shift in corporate law is illustrated in *Paramount Communications, Inc. v. Time Inc.*²²⁶ In this case, after Time and Warner agreed to merge, Paramount announced a tender offer for Time. The Time board favored the Warner merger, viewing the Paramount bid as a threat to Time's corporate culture of editorial independence and journalistic integrity. Time and Warner restructured their transaction to block the Paramount proposal. The Delaware Supreme Court stated that Time did not place itself on the auction block merely by pursuing its long-term business strategy to merge with Warner.²²⁷ Thus, the *Paramount* case came close to explicitly sanc-

²²⁴ Weiler does not give much priority to the "empty promise" of codetermination. WEILER, *supra* note 196, at 220. He states, "lodging essentially unilateral control in management is not a recipe for exploitation." *Id.* at 217.

²²⁵ See, e.g., Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865 (1990); Lyman Johnson & David Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 533 (1990).

²²⁶ 571 A.2d 1140, 1151-52 (Del. 1989).

²²⁷ 571 A.2d at 1153. For further discussion of this case, see Lyman Johnson & David Millon, *The Case Beyond Time*, 45 BUS. LAW. 2105 (1990). Many cases decided during the takeover era illustrate how the legal model of the firm is changing to consider employee concerns. For example, in *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 257 (Del. Ch. 1989), the special employee relationship elements led the Court to sustain the use of an employee stock option plan (ESOP) to prevent a takeover. In *Sham-*

tioning the "just say no" defense. It established that directors have no duty to maximize the shareholders' short-term value and that directors may take into account the interests of other constituents when making decisions.²²⁸

State legislatures enacted antitakeover statutes in response to concerns that nonshareholder constituents need protection from corporate restructuring. Specifically, over one-half of the states adopted such statutes designed to broaden directors' discretion to resist takeovers by considering the interests of employees, suppliers, customers, and other nonshareholder constituents.²²⁹ With one exception, the stakeholder statutes are permissive; that is, they do not compel directors to address the needs of nonshareholder constitu-

rock, the court held that an ESOP funded through wage concessions was "shareholder neutral." This led the court to lower the degree of scrutiny in reviewing the board action surrounding the defensive tactic. *Id.* at 275 76.

In *Ypsilanti v. General Motors Corp.*, No. 92-43075CK, 1993 WL 132385 (Mich. Cir. Ct. Feb. 9, 1993), Washtenaw County Judge Donald Shelton ordered General Motors to keep its Willow Run plant open based upon promissory estoppel. Judge Shelton found that General Motors made statements that it would keep the plant open if "favorable market demand" justified it. In reliance upon these statements, the Township of Ypsilanti gave \$1.3 billion in tax abatements to General Motors. Judge Shelton stated:

Industry is a source of many of the jobs in our nation and it may well be that our nation needs a new relationship of trust and cooperation between government and industry in order to compete with heavily subsidized industries from other . . . countries. But such an effort must be national in scope and must be a *real* partnership with industry, not one in which industry simply views government as . . . another opportunity to increase profits. . . . This tax subsidy policy results in pitting state against state and municipality against municipality in an inter-governmental bidding war. The local governments of this State are placed in a position where they feel that they have no choice but to give taxpayers' resources away under a statute which does not mandate that they receive anything in return for those forgone taxes. Moreover, it has been recognized by reputable economics scholars for over ten years that the tax subsidy program, at least as adopted in Michigan, simply does not work and has little if any effect on industry investment or location decisions.

Id. at 21-22.

In another case, the District Court of New Jersey allowed an innovative claim against a raider by workers who lost their jobs as a result of the use of defensive leveraging; the employees brought suit on the basis that the raider tortiously interfered with their employment contract. *Glass Molders, Putty, Plastics, and Allied Workers Int'l Union v. Wickes Co.*, 707 F. Supp. 174, 179-80 (D. N.J. 1989). For a discussion of the *Glass Molders* case, see Allan Kanner, *Protecting Workers From Unlawful Interference With Their Jobs*, 10 HOFSTRA LAB. L.J. 171 (1992). Outside the takeover context, the Delaware Chancery Court recently indicated that directors may consider "the best interests" of the corporation, rather than just the shareholders' interests once the corporation reaches the "vicinity of insolvency." *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp.*, No. 12150, 1991 WL 277613, at *33 n.55.

²²⁸ 571 A.2d at 1153.

²²⁹ For extensive treatment of these statutes see *Symposium: Corporate Malaise—Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 1 (1991); see also Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Consistency Statutes*, 61 GEO. WASH. L. REV. 701 (1992).

ents. To date, the courts have not interpreted the scope of these provisions. Although takeover activity has decreased, this legislation may have a profound impact upon corporate law because most of the statutes are worded broadly to encompass any business decision.

This review of judicial and legislative responses to the takeover era demonstrates that corporate law is undergoing significant paradigmatic changes.²³⁰ Allowing directors to consider employee interests in corporate restructuring significantly alters the legal model of the corporation. In the past, corporate law did not concern itself with the needs of various nonshareholder constituencies because contract law, rather than fiduciary duty, determined management's obligations to these groups. The courts and legislatures have not explicitly stated the basis for expanding directorial responsibilities to nonshareholder constituents. Employees, however, are the constituent mentioned most often in discussions concerning directors' duties to nonshareholders. Similar to recent inroads upon the employment-at-will doctrine,²³¹ the shift in corporate law may reflect social values that are more receptive to recognizing that employees

²³⁰ Jeffrey Gordon notes that "the *Paramount* decision portends a change in the socio-legal culture of corporate law." Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1933 (1991). He continues:

Certainly in the constitutional realm courts have become comfortable with the idea that their decisions gain legitimacy from an emerging social consensus and properly play a role in shaping that consensus as well as heralding it. . . . Yet, unlike constitutional law, the shaping of corporate law has seemed a more technical enterprise, removed from broad social impulses.

Id. at 1981 (footnote omitted). Gordon concludes that "*Paramount* can best be understood as a judgment that a self-regulating market such as an unbridled market in corporate control, threatens fundamental social values such as loyalty, continuity, and community, and, that at the very least, takeover activity needed to be slowed down." *Id.* at 1933; see also David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 252 (noting that the *Time* decision acknowledges the public significance of corporate activity).

²³¹ For the most part, the current exceptions to employment at-will do not provide a remedy for opportunistic breach of an implicit contract. Yet, there is some movement in this direction. Regardless of the employer's formal or express intention, it is sufficient for some courts that a worker draw inferences of an implied contract of employment from the employer's statements or behavior. For example, in *Toussaint v. Blue Cross & Blue Shield*, 292 N.W.2d 880, 892 (Mich. 1980), the court stated that, in establishing personnel policies and practices: "The employer secures an orderly, cooperative and loyal work force, and the employee the peace of mind associated with job security and the conviction that he will be treated fairly." The court found that reliance upon statements in an employees' manual gives workers a cause of action. *Id.* at 885.

In *Fortune v. National Cash Register Co.*, 364 N.E.2d 1251 (Mass. 1977), the employer fired a salesman to avoid paying a large commission bonus under the employment contract, representing a clear attempt by the firm to appropriate the employee's wages. The Massachusetts Supreme Judicial Court supplied a covenant of good faith and fair dealing into Fowler's employment contract, and awarded him his bonus. *Id.* at

make significant investments in the firm that depend upon how directors manage the corporation's affairs.

Although these changes in corporate law reflect a greater concern for nonshareholder constituents, they are inadequate because employees do lack the right to challenge decisions made on their behalf. For this reason, some corporate scholars assert that courts should provide nonshareholder constituents with standing to sue for breach of directorial fiduciary duties.²³² In their proposals for reform, these commentators also include nonshareholder constitu-

1255-56. So far, however, the courts in Massachusetts have not extended the holding in *Fortune* beyond cases of wrongfully withheld commissions.

Explaining the impetus behind these changes in the employment-at-will doctrine, Clyde Summers states:

[T]he courts and legislatures have built on an underlying assumption, more nascent than fully developed, that the employee has a valuable interest in his or her job which ought not be arbitrarily taken away. This assumption is implicit in the breakdown of the employment at will doctrine, for it is the courts' sense of that valuable interest which spurs them to develop legal theories which will provide protection.

Summers, *Labor Law*, *supra* note 214, at 15.

²³² Recently, several commentators have proposed models that include standards for assigning weights to the interests of various constituents. Some of these models do not grant nonshareholders standing to sue. For example, Morey McDaniel asserts that directors should act as bargaining agents for stakeholders as well as shareholders. Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121 (1991). His model replaces the single goal of shareholder wealth maximization with the dual goal of "maximiz[ing] stockholder gain" while "minimiz[ing] stakeholder loss." *Id.* at 137. In pursuing this dual goal, McDaniel recommends three guidelines. First, the board should reject any proposal where stakeholders lose more than shareholders gain. *Id.* at 131-32. Second, if shareholders gain more in a transaction than stakeholders lose, directors should ensure that stakeholders are compensated. *Id.* at 132-33. Finally, under the most controversial proposal, directors may allow stakeholders to share in the gain beyond any compensation for loss, because stakeholders also bear residual risk. *Id.* at 135-36. However, any benefits awarded to stakeholders must bear a reasonable relationship to the benefits received by shareholders. Under another model, Stephen Bainbridge argues that *Unocal* provides an appropriate framework for applying the nonshareholder constituency statutes to all structural decisions. Stephen Bainbridge, *Interpreting Non-shareholder Constituency Statutes*, 19 PEPP. L. REV. 971 (1992).

Other commentators have formulated models that provide nonshareholder constituents with standing to sue. David Millon recommends three standards to guide directors. Millon, *supra* note 5, at 265-68. First, directors should not seek short-term shareholder gain if such action will harm legitimate nonshareholder investments. *Id.* at 266. Second, directors should "harmonize the shareholders' financial interest and nonshareholder interests in stable relationships with the corporation." *Id.* at 267. Finally, "management should honor the legitimate expectations of nonshareholder constituencies if abrogation of existing relationships is necessary to serve the larger interests of the corporate enterprise as a whole." *Id.* at 268.

Professor Lawrence Mitchell advocates that courts use the close corporation test to balance conflicting interests. Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 379 (1992). That is, after nonshareholder constituents prove injury, the board should bear the burden of demonstrating a legitimate corporate purpose. *Id.* at 636. Then, nonshareholder constituents should be allowed to prove that an alternative less harmful to their investments existed for the board to pursue. *Id.*

ents other than employees such as customers, bondholders, suppliers, and the local community. In contrast, I focus on nonmanagerial employees because they are the most vulnerable constituents and they have the most direct relationship with the corporation. In addition, an adverse impact on employees tends to have a similar impact on other nonshareholder constituents who rely on the corporation. I have relied upon the stakeholder statutes, as well as general fiduciary principles, to argue that directors should owe a fiduciary duty to provide adequate severance pay, job retraining, and other benefits to dislocated workers in plant closings and layoffs.²³³ In the next section, I expand upon this work by exploring how the neutral referee model may facilitate adjustments that are necessary for American firms to respond to global market pressures.

B. Proposal to Reform the Legal Model of the Corporation to Recognize Employees' Stake in the Firm

1. *Directorial Fiduciary Duties to Employees*

a. *Fostering Trust in the Workplace*

Fiduciary law best transforms the gift-exchange aspects of implicit employment agreements into the language of the law because the heavy moral overtones of fiduciary obligation encompass the spirit of mutual respect, solidarity, and confidence that arise in the workplace. Fiduciary law would protect these noncontractual expectations because this doctrine imposes a higher standard of conduct than that customarily accepted by the marketplace under the contractual duty of good faith.²³⁴ In this way, fiduciary law would encourage employee trust and reliance upon the new implicit employment agreements under participatory work programs.

Fiduciary doctrine would facilitate participatory work programs because this doctrine would reflect the notion that trust in the employment relationship is fragile. If firms fail to abide by the terms of the gift exchange, cooperation may quickly unravel in the absence of the stabilizing influence of fiduciary duty. Under the existing legal regime, workers and managers may fail to develop a high degree of mutual trust because the law, and the cultural practices it makes possible, habituate the parties to certain ways of viewing their association. Whereas fiduciary duties have a tendency to foster stable patterns of cooperation, the lower duty of good faith that governs at-will employment may reinforce the counterpatterns of exploita-

²³³ 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).

²³⁴ See, e.g., Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879 (company obligations under contractual and fiduciary duties).

tion and conflict. Legally acknowledging that employees are members of the firm through corporate law may reshape this conditioning of preferences; the new fiduciary duty would symbolize that workers and shareholders are partners in the enterprise who have common interests in increasing the internal efficiency of the firm. Viewed in this light, fiduciary law provides a loyalty filter that would serve a preference-shaping function by encouraging the parties to build ties of affection and loyalty that are needed to overcome the prisoners' dilemma problem inherent in the productivity game.²³⁵

More specifically, fiduciary law would facilitate participatory work programs because the possibility of legal sanctions would provide some assurance to employees who are uncertain about whether to trust managers.²³⁶ Indeed, the very existence of judicial recourse for breach of fiduciary duty may deter opportunistic behavior by firms.²³⁷ By reducing the risks of trust, fiduciary law would provide support for cooperative corporate cultures by allowing employees to rely upon systems trust.²³⁸ This systems trust would signal that in the future, the parties' relationship will be based on mutually beneficial understanding and flexibility rather than on strict adherence to legal rights and contract terms.²³⁹ Accordingly, fiduciary doctrine would preserve the atmosphere of good will in the workplace and thus better enable managers and workers to adjust to external market pressures.²⁴⁰

In contrast, Williamson warns that the adversarial atmosphere of a courtroom is detrimental to the quality of the employment rela-

²³⁵ For a general discussion of the role of the law as a preference-shaping institution, see Cass R. Sunstein, *Legal Interference with Private Preferences*, 53 U. CHI. L. REV. 1129 (1986) (changing preferences reflect the moral function of the law).

²³⁶ Cf. BARBER, *supra* note 129, at 23 ("[T]rust is weakened if those who have become justifiably distrustful have no recourse to the law and its controls.").

²³⁷ See, e.g., Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1228 (1990) ("The [judicial role] expresses a societal recognition that fair treatment in business relationships is both an important and desirable value. The shift from telling parties to look out for themselves to encouraging cooperative efforts ought to inspire management to a higher level of behavior."); G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221 (1991) (discussing role of law in promoting trust).

²³⁸ Bratton, *supra* note 131; cf. J.A.C. Hetherington, *The Minority's Duty of Loyalty in Close Corporations*, 1972 DUKE L.J. 921, 946 ("[The] imprecise concept of fiduciary responsibility, at least as applied to majority shareholders . . . has clearly promoted fair dealing within business enterprises.").

²³⁹ Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963) (the willingness of the parties to cooperate is derived from their desire to preserve commercial relationships and to avoid damage to their business reputations).

²⁴⁰ See generally IAN MACNEIL, *THE NEW SOCIAL CONTRACT* (1983).

tionship.²⁴¹ Williamson raises an important point because "trust cannot be reduced to trust in the law and in the sanctions which the law makes possible."²⁴² Otherwise, managers would act out of fear of legal sanctions and not from the emotional feelings of trust.²⁴³ Although to a certain extent the signals needed to start a trusting relationship are weakened by fiduciary obligation, these signals would retain sufficient force to promote the trust-building process in the employment context.²⁴⁴ Even though fiduciary law would provide protection from opportunistic conduct by firms, the need for employee trust remains because fiduciary obligation would not fully compensate all breaches of trust. Because of the substantial discretion and power entrusted to the fiduciary, and the consequent difficulty of detecting fiduciary breach, fiduciary duties must be somewhat self-enforcing.²⁴⁵ Fiduciary law promotes this self-enforcement by using a language of moral obligations that would provide incentives for directors to act ethically and to assume greater awareness of and respect for the needs of workers.

The signals for trust provided by fiduciary law will not be effective if managers attempt to use them in an instrumental manner just to increase efficiency. Under the neutral referee model, the most effective managers will be those that are committed in their minds and hearts to recognizing that employee participation in workplace governance is valuable because it achieves human values by enhancing worker dignity.²⁴⁶ In short, fiduciary obligations to employees enable managers to increase the internal efficiency of the firm through their own genuine feelings of trust and acceptance of corporatism.

Fiduciary duty would foster cooperative labor relations because the development of trust requires that the calculation regarding the impact of legal rules upon the relationship remains latent. For this reason, the atmosphere of trust is destroyed when managers and workers engage in extensive collective bargaining negotiations that produce 500 page documents because it puts workers and managers on their guard by making them suspicious of the motives of the other. In contrast, the Saturn project agreement between General

²⁴¹ Williamson, *supra* note 19, at 256 ("Adjudicatory review of the decisions of certain institutions, while perhaps insuring a 'better' decision in some objective sense, can only disrupt on-going relationships within the institution and thereby hamper the institution's ability to serve its designated societal function." (quoting Justice Rehnquist, Address at the University of Miami School of Law (Feb. 2, 1978))).

²⁴² LUHMANN, *supra* note 129, at 35.

²⁴³ *Id.* at 34.

²⁴⁴ *Id.* at 35-36.

²⁴⁵ Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 830 (1983) (observing the fiduciary law encourages "altruistic and moral behavior").

²⁴⁶ See *supra* text accompanying note 134.

Motors and the United Auto Workers consists of only 20 pages, which clarify their mutual goals in establishing an employee participation committee to govern their relationship.²⁴⁷ Fiduciary law would provide protection to workers who rely upon these types of documents without destroying the energizing atmosphere of trust that emerges when embarking upon a new approach to labor relations. In these situations, fiduciary obligations to workers would serve as a back-up system seldom used actively, but always used passively.²⁴⁸

Indeed, legal regulation appears to have had this type of positive influence in Germany where the employment relationship is perceived not so much as one of confrontation between workers and management, but one of encompassing workers as members in the enterprise.²⁴⁹ In contrast to the adversarial approach of collective bargaining that exists in the United States, German Works Council relations adopt a different perspective that is expressed in Section 2 of the Works Constitution Act: "The employer and the works council shall work together in a spirit of mutual trust . . . for the good of the employees and of the establishment."²⁵⁰ This cooperative atmosphere is also reflected in Section 74, which directs that workers and managers "shall discuss the matters at issue with an earnest desire to reach agreement and make suggestions for settling their differences."²⁵¹

This analysis of the role that fiduciary duty would play in fostering trust in the workplace provides the foundation for a broader evaluation of the neutral referee model. Under the referee model, the most successful directors will win the trust and acceptance of both employees and shareholders in their role as mediators. Conventions that facilitate this acceptance could arise, in part, through the development of legal standards that provide guiding principles for the board to use in striking a balance between the interests of employees and shareholders.²⁵² Thus, the next section continues to explore the use of fiduciary law to regulate the employment relationship by examining the legal standard that would govern the directors' obligation to protect employees from opportunistic conduct by firms.

²⁴⁷ WEILER, *supra* note 196, at 36-37.

²⁴⁸ Macaulay, *supra* note 239 (parties in long-term business relationships chose to litigate only when reputational sanctions fail, usually in situations involving high stakes or the termination of the relationship).

²⁴⁹ Summers, *supra* note 170, at 370.

²⁵⁰ The Works Constitution Act of 1972 § 2.

²⁵¹ *Id.* § 74.

²⁵² Aoki, *supra* note 50, at 18-22.

b. *The Legal Standard Governing the Directors' Obligation to Protect Employees From Opportunistic Conduct*

Many American directors currently view their role as balancing the interests of employees and shareholders, but not as neutral arbiters.²⁵³ When the shareholders' and employees' interests directly conflict in situations like plant closings and layoffs, studies indicate that directors refrain from expressing their moral sentiments about employees due to their belief that they have a legal obligation to maximize shareholder wealth.²⁵⁴ By absolving directors from their responsibility to act as moral agents, the current legal regime promotes an end-game problem that threatens collaboration in the employment relationship. The neutral referee model would remedy this end-game problem by ensuring that firms do not defect during the last round of the productivity game. A legal standard is needed that both shields the shareholders from managerial self-interest and prevents the expropriation of the employees' firm-specific investments.

Other areas of the law can provide useful analogies in formulating this legal standard. Similar situations arise when courts review directors' decisions to engage in transactions that may benefit the majority stockholders at the expense of the minority stockholders and when they examine trustees' decisions to allocate investment proceeds among beneficiaries. In these situations, courts use a fairness test that requires substantive review to ensure that the beneficiaries's expectations are not defeated.²⁵⁵ Courts consider the whole relationship to determine whether the fiduciary has fulfilled its duty to the competing beneficiaries. For example, in the trust context, courts evaluate the trustee's decision to allocate trust funds between beneficiaries according to the primary duty to conserve the trust property. In a similar way, the neutral referee's decisions should be governed by an overall duty to maximize X-efficiency by minimizing the negative impact that strategic decisions have upon employees.

Most commentators reject the neutral referee model by assuming that directors cannot serve two masters and that courts will simply defer to the directors' business judgment. True, a standard

²⁵³ Nesteruk, *supra* note 151, at 93 (citing JAY LORSCH & ELIZABETH MACIVER, *PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS* (1989)); *see also* Larry O. Soderquist & Robert P. Vecchio, *Reconciling Shareholders' Rights and Corporate Responsibility: New Guidelines for Management*, 1978 DUKE L.J. 819 (stating that stockholders also see directors' role as encompassing interests of nonshareholder constituents).

²⁵⁴ Nesteruk, *supra* note 151, at 93.

²⁵⁵ D. FINN, *FIDUCIARY OBLIGATIONS* 56-58 (1977) (general discussion of competing beneficiaries); HODGE O'NEAL, *OPPRESSION OF MINORITY SHAREHOLDERS* 120-23 (2d ed. 1992).

requiring directors to balance the claims of employees and shareholders is not as easy to visualize as the shareholder wealth maximization objective. Yet, directors of worker cooperatives, employee-owned firms, and codetermined firms must also face the real world problems of integrating the conflicting concerns of employees and shareholders.²⁵⁶ A greater understanding of these alternative systems of corporate governance will further develop the neutral referee model.²⁵⁷

Other commentators claim that because implicit agreements are not verifiable to third parties such as courts, this lack of verifiability prevents legal enforcement of these arrangements.²⁵⁸ Unfortunately, the terms of implicit agreements are not well-defined. If they were, employees could sue to enforce them as implied contracts.²⁵⁹ Yet, most fiduciary relationships involve implicit agreements; the fact that the terms are not explicit does not prevent courts from protecting the beneficiaries from opportunistic conduct.²⁶⁰ This is because courts uphold the norms and conventions that develop during the history of the underlying relationship.²⁶¹

²⁵⁶ German directors are charged by law to carry out their responsibilities in the "interests of the company." Aktiengesetz § 93 (1965).

²⁵⁷ Unfortunately, however, little data exists concerning how directors balance competing interests in these firms.

²⁵⁸ KREPS, *supra* note 79, at 110; Carl Shapiro & Joseph E. Stiglitz, *Equilibrium Unemployment as a Worker Discipline Device*, 74 AM. ECON. REV. 433, 442 (1984).

²⁵⁹ Joseph Singer has proposed the use of "a reliance interest in property" to protect employees in plant closings. He asserts:

It matters very little whether the reliance interest in property is conceptualized as a doctrine of property law, contracts, torts, trusts, labor law, corporate law, or anything else. The divisions between these areas of the law exist merely for convenience, and it seems that rigid categorization hampers analysis. A more unified analysis of entitlements is useful, as the law and economics writers have convincingly demonstrated.

Joseph Singer, *The Reliance Interest in Property*, 40 STAN. L. REV. 614, 700 n.309 (1988); see also Jay M. Feinman, *The Meaning of Reliance: A Historical Perspective*, 1984 WIS. L. REV. 1373, 1389 (extending reliance doctrine to grant employees rights in the workplace).

²⁶⁰ Courts often use fiduciary duty to prevent inequitable conduct that seems permissible under the explicit terms of a contract or statute. Many close corporation cases reveal that the fiduciary duty notion can be used to avoid the explicit terms of a contract. Most notably, Judge Easterbrook has stated that all contracts contain an implied fiduciary term that neither side will behave opportunistically. *Jordan v. Duff & Phelps*, 815 F.2d 429, 438 (7th Cir. 1987), *cert. denied*, 485 U.S. 901 (1988). Judge Easterbrook implied that a narrow fiduciary duty arises from the employment at-will arrangement. The court found a duty to disclose based upon an implied fiduciary duty to refrain from opportunistically buying back stock. See also *Page v. Page*, 359 P.2d 41 (Cal. 1961) (invoking use fiduciary duty to prevent partner from using power to terminate at-will partnership to expropriate gains); *Topper v. Park Sherwood Pharmacy*, 433 N.Y.S.2d 359 (Sup. Ct. 1980) (protecting at-will employee/shareholder in close corporation context by invoking fiduciary duty).

²⁶¹ *Id.*

Thus, fiduciary law reflects the changing nature of the employees' investments in the firm.²⁶²

The vague moral duties in fiduciary law would allow the specific obligations to employees to be formulated on a case-by-case basis and provide the courts with discretion to tailor relief to the particular situation.²⁶³ Perhaps the most serious practical difficulty courts would face is determining the amount of compensation necessary to make employees whole for their firm-specific investments after plant closings and layoffs. Although precise measurement may not be possible, these problems are not insurmountable. Analogies may be drawn to age discrimination litigation that has developed the concept of "front pay." This remedy reflects the notion of implicit employment agreements because it compensates workers for losing the future value of their investments in the firm and having to begin their career again at the bottom of the job ladder with a new employer.²⁶⁴ Another option would be to enact statutory safeharbors that establish minimum rights for workers. For example, a satisfactory solution would include the right to substantial severance pay scaled according to length of service.²⁶⁵ Such safeharbors would ease the implementation of the neutral referee model by providing directors with guidelines, while concurrently permitting judicial expansion of the directors' duty not to engage in opportunistic conduct.

Although the transition to the neutral referee model would incur organizational and societal costs, the success of the German system in integrating the employees' voice in corporate governance suggests that substantial X-efficiency advantages would be obtained in the long-run. The next section continues to explore these inter-

²⁶² Bratton, *supra* note 131 (fiduciary duty is not "alien morality imposed on business people by the state").

²⁶³ This proposal represents a marked departure from the conventional method of regulating corporate behavior; the traditional method calls for complex and detailed legislation. Corporate scholars favoring internal reform over external regulation argue that if the corporations' institutional structure remains unchanged, the reasons prompting government regulation may lead to more regulation. RALPH NADER ET AL., *TAMING THE GIANT CORPORATION* (1976); CHRISTOPHER D. STONE, *WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR* (1975); Alfred Conard, *Reflections of the Public Interest Director*, 75 MICH. L. REV. 941 (1977).

²⁶⁴ *Cf.* WEILER, *supra* note 196, at 248 (recommending this remedy be used to compensate victims of unfair labor practices under the NLRA). For an expanded discussion of front pay, *see, e.g.*, Brian S. Felton, *Jury Computation of Front Pay Under the Age Discrimination in Employment Act*, 76 MINN. L. REV. 985 (1992) (arguing that courts should allow juries to calculate front pay).

²⁶⁵ Massachusetts enacted a statute, the first of its kind in the nation, which provides that any employee terminated within two years after a change in corporate control is eligible for a lump sum payment equal to twice the employee's weekly compensation, times the number of years of service. MASS. GEN. L. ch. 149, § 183(b) (1988). This statute, however, only applies to takeover-related job loss.

nal efficiency aspects by examining how the neutral referee model attains the advantages of the German system.

2. *The Neutral Referee Model: A Variation on Codetermination*

The neutral referee model resembles the German system of codetermination by granting participation rights in recognition of the employees' investments of human capital. Yet, similar to the German system, workers' firm-specific investments would not entitle them to a direct portion of residual earnings of the firm. Although workers would not have the right to attend board meetings, the neutral referee model offers workers indirect worker participation at the board level by altering the way that directors balance the interests of shareholders and employees. The neutral referee model also parallels the German system because this governance structure would include Employee Participation Committees that require managers to provide information and consult with employees.²⁶⁶

a. *The Duty to Disclose Information to Employees*

The neutral referee model requires directors to inform employees about issues traditionally categorized as managerial prerogatives. Fiduciary law is an appropriate mechanism to facilitate this aspect of the neutral referee model because disclosure is a prominent feature of fiduciary doctrine.²⁶⁷ Disclosure obligations would reflect the need for managers and workers to develop openness and honesty with one another, rather than attitudes of skepticism and distrust that currently prevail in the workplace.²⁶⁸

Because this new model of corporate governance seeks to make workers and shareholders partners in the enterprise, it is appropriate to turn to the Uniform Partnership Act to develop standards for disclosure to employees. Under the Uniform Partnership Act, partners must render "on demand" full information concerning partnership affairs.²⁶⁹ Access to the partnership books is one aspect of the partners' overriding duty to share information. In some situa-

²⁶⁶ Smooth mediation and representation of diverse interest among employees by a single representative body for employees is crucial. Aoki, *supra* note 50, at 16-22. This single representative body must accommodate the most heterogeneous workforce that has ever existed in this country. WEILER, *supra* note 196, at 5-6.

²⁶⁷ In general, parties have no duty to disclose in arms length bargaining. This rule, however, is changing. See, e.g., Johnson v. Davis, 480 So. 2d 625 (Fla. 1985) (imposing duty to disclose on sale of residence).

²⁶⁸ ALAN R. BROMBERG & LARRY E. RIBSTEIN, PARTNERSHIP § 6:63 (1991).

²⁶⁹ Section 20 states: "Partners shall render on demand true and full information of all things affecting the partnership to any partner or the legal representative of any deceased partner or partner under legal disability." UNIF. PARTNERSHIP ACT § 20. As to the duty owed by agents and trustees, see RESTATEMENT (SECOND) OF AGENCY § 381; RESTATEMENT (SECOND) OF TRUSTS § 173.

tions, courts have held that this duty is breached by a failure to make affirmative disclosure even in the absence of an explicit demand. In general, no demand is required if the circumstances indicate that the party entitled to disclosure is relying on the other party to volunteer it. The extent of this broader duty to disclose depends on several factors, such as the parties' access to financial records, whether the nondisclosing partner managed the business and thus was familiar with the relevant information, and whether the party to whom the duty of disclosure is owed had the requisite knowledge or expertise to protect herself.²⁷⁰

By analogy, directors should be required to provide employees with regular and detailed information about the firm's personnel policies and the broader financial condition of the firm.²⁷¹ Workers would also have the right to demand any additional information necessary to evaluate issues pertaining to working conditions and job security. In order to obtain the X-efficiency benefits from enhanced communication within the firm, the neutral referee model would establish Employee Participation Committees that could evaluate this information and consult with managers about strategic policies of the firm.

b. *Employee Participation Committees*

Under the neutral referee model, Employee Participation Committees would consult regularly with management about decisions concerning the general economic condition of the firm. These strategic decisions would focus primarily upon employment issues such as compensation, hiring and training, technological innovations, work assignments, and layoffs and work reassignments.

These types of representative bodies would permit managers to take full advantage of the knowledge and skills of the workforce by allowing discussion of problems as they unfold. In addition, through continual communication and negotiation, representatives of labor and management may come to trust and cooperate with each other to a much greater degree. Indeed, Works Councils in Germany have demonstrated the capacity to reduce substantially the conflicts that arise during industrial transition. Because fiduciary law would provide judicial recourse for employees, and firms will try to avoid litigation, there is reason to believe that this consultation will be effective. That is, directors are not likely to make any impor-

270 BROMBERG & RIBSTEIN, *supra* note 268, § 6:64.

271 Leslie K. Sheldin, *Regulation of Disclosure of Economic and Financial Data and the Impact on the American System of Labor-Management Relations*, 41 OHIO ST. L.J. 441 (1980) (discussing how to create greater labor-management cooperation through disclosure).

tant strategic decisions without first considering the possible reactions of the Employee Participation Committee.²⁷²

Employee Participation Committees, as well as traditional unions, would also aid employee efforts to exercise their rights as beneficiaries of the new fiduciary obligations. Many commentators are concerned that providing employees with additional legal rights will produce a flood of litigation.²⁷³ In contrast, Paul Weiler emphasizes the limited uses and value of the labor law in the workplace. Weiler explains that the employees' ability to detect and complain about violations of their rights depends on their widely varying intellectual, financial, and organizational resources.²⁷⁴ Thus, Employee Participation Committees are necessary to give employees a better chance to take advantage of their legal rights by providing financial support and counseling. In this way, these committees would improve the likelihood that the broader goals of the neutral referee model would be achieved.

3. *The Advantages of the Neutral Referee Model Over German Codetermination*

The neutral referee model not only accomplishes the same goals as the German system of codetermination, it also may offer two advantages. First, codetermination involves a potential threat that industrial conflict at the board level could seriously impede the process of directorial decisionmaking. In contrast, the neutral model may provide a more efficient institutional device to resolve the competing claims of employees and shareholders. In analyzing employee-owned firms, Henry Hansmann suggests that "fiduciary mechanisms may generally be a more effective substitute for the market than are political institutions: Firms managed *for* their workers, it appears, often perform better than firms managed *by* their workers."²⁷⁵ Game theory also suggests that the neutral referee model may reduce the potential for adversarial behavior because the board can make rational group decisions rather than allowing the

²⁷² Aoki, *supra* note 50, at 18-22.

²⁷³ Alfred Conard asks:

Why, then should not employees . . . be permitted to maintain derivative suit? There does not seem to be any very good reason for giving them less rights than shareholders. The real reason for withholding the derivative suit from employees is probably a belief that derivative and class suits are often abused, and that broadening the right to sue would broaden the abuses.

ALFRED CONARD, CORPORATIONS IN PERSPECTIVE 405 (1978).

²⁷⁴ WEILER, *supra* note 196, at 28-29 (noting that wrongful dismissals are usually filed by professional employees rather than unskilled workers).

²⁷⁵ Hansmann, *supra* note 176, at 1816.

outcome to depend on the self-interested decisions of the two competing groups.²⁷⁶

The neutral referee model not only resolves competing claims in a more efficient manner but also may be more politically acceptable than reform proposals for codetermination. Codetermination may not necessarily be transferable to this country where different ideas of labor-management relations prevail.²⁷⁷ In the past, the strong aversion of employers to worker participation in basic entrepreneurial decisions precluded much discussion about codetermination. In contrast, the neutral referee proposal draws upon existing managerial customs and conventions in the United States. In addition, the neutral referee model builds upon recent legal changes in directorial fiduciary responsibilities of the takeover era. Also, given the anti-union sentiment that pervades in the business community and the growing interest in employee involvement committees, these proposals may be more favorably received than attempts to reform collective bargaining.²⁷⁸

The neutral referee model would promote evolution in the positions and attitudes of managers and workers by allowing the process of reform to build upon existing business practices and

²⁷⁶ Aoki, *supra* note 50, at 18-22. Hansmann suggests that the fiduciary duty that governs these plans should be viewed as an alternative to the market and political methods of making social choices. Hansmann, *supra* note 176, at 1816. Bruce Chapman has extended this analysis suggesting that the fiduciary mechanism operates as a solution to prevent inefficient cycling in the context of directorial fulfilling duties to competing beneficiaries. Chapman, *supra* note 130. He explains the "restricted voice" used by Gordon and Hansmann as a method of securing a "structure induced" equilibrium against political cycling, so "restricted exit" needs to be used to ensure that there is no contractual cycling. *Id.*

Hansmann suggests that extreme forms of devices to reduce conflict can be found in those firms in which the board consists of outsiders who are self-appointing and not removable except for cause. In these situations, the board is charged with managing the firm as fiduciaries on behalf of the workers rather than being elected by them. He cites as examples the "worker cooperatives" in Britain and Weirton Steel Company. Henry Hansmann, *Worker Participation and Corporate Governance*, U. TORONTO L.J. (forthcoming 1993). Lawrence Mitchell has proposed a similar solution in reforming the directors' fiduciary duties to encompass obligations to nonshareholder constituents. Lawrence Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263 (1992). He suggests creating an independent board that is a self-perpetuating body. Under this proposal, various corporate constituents would be given the right to sue to remove directors for cause. *Id.*

²⁷⁷ Ronald M. Sharp, *Codetermination: A Postmortem*, 40 LAB. L.J. 323, 333 (1989) ("[C]odetermination is not about to sweep industrial relations in this country."); KIM MOODY, AN INJURY TO ALL: THE DECLINE OF AMERICAN UNIONISM 191 (1988) (arguing that cooperation will not lead to codetermination because of socialist tradition and powerful unions in European countries).

²⁷⁸ Because labor law reform is intensely controversial, Weiler suggests that political realism requires workers to invest their limited political leverage where it will have the highest payoff. WEILER, *supra* note 196, at 228. Yet, he "give[s] comparatively little political priority" to "empty promise" of codetermination. *Id.* at 297-98.

theories. In the future, workers may gain political leverage as economic pressures induce new openness to ideas that have not commanded support in the past.²⁷⁹ Thus, in time, the neutral referee proposal may lead to additional measures that would advance workplace democracy.²⁸⁰

CONCLUSION

Responding to the demands of an international marketplace, firms have adopted new shopfloor practices that depend on worker's communicating crucial knowledge. As Robert Reich explains: "our economic future must be rooted in the only resource that will remain uniquely American: Americans themselves."²⁸¹ Yet, the changing practices on the shopfloor present a prisoners' dilemma: although these programs present an opportunity for workers and firms to profit mutually, the atmosphere of mistrust that prevails in the workplace increases the potential for mutual loss. The capacity to overcome this prisoners' dilemma will depend partly upon the availability of alternative organizational structures that promote cooperative corporate cultures. Thus, the United States faces a cultural challenge to create organizational devices that encourage collaboration and prevent exploitation. This Article has presented an alternative model of corporate governance that revises directorial fiduciary duties to promote a high level of employee trust and commitment.

To expand worker influence inside the firm in a manner that enhances X-efficiency, this Article maintains that the reconstruction of corporate law must accompany the reconstruction of labor law. This period of transformation in the workplace suggests that labor law and corporate law scholars should seek common understanding through dialogue concerning viable corporate governance mechanisms to meet the needs of American workers in a global world economy. Corporate scholars need to rethink traditional solutions to corporate governance to accommodate the employees' changing role in the corporate structure. Similarly, labor scholars should begin looking at issues concerning institutional shareholders because the employees' role in the codetermined firm is only half of the story.

²⁷⁹ *Id.*

²⁸⁰ Klare, *Debate, supra* note 5, at 69 ("It remains to be seen whether cooperation schemes of the kind now in vogue can act as an entering wedge in a process designed to achieve genuine power sharing and workplace democratization."). *But see* Wilson McLeod, *Labor-Management Cooperation: Competing Visions and Labor's Challenge*, 12 *INDUS. REL. L.J.* 233, 241 (1990) ("[T]he current cooperation debate does not create an opening for serious discussion of worker participation.").

²⁸¹ REICH, *supra* note 1, at 13.