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Stakeholders and Takeovers: Can Contractarianism be Compassionate?

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Abstract
The issue of what, if any, purchase non-shareholder corporate constituencies (that is, employees, creditors, suppliers, customers, and communities) should have on the discretionary decisions of corporate management has proved to be one of the most durable, if not vexing, issues in modern corporate scholarship. Most recently, the issue has resurfaced in the context of the takeover wave of the 1980s, particularly during the latter part of the decade when control transactions became associated with high levels of leverage. At core, stakeholder advocates were riveted by the asymmetries involved in change-of-control transactions. While target shareholders earned consistent and sizeable returns from these transactions, stakeholders were left in the cold. Indeed, in some cases, control transactions were thought to be capable of inflicting highly focused losses on stakeholders. So severe were these losses that some commentators, were led to conclude it was the gains from opportunistic breaching of stakeholder contracts that motivated the transactions in the first place.

As in the past, participants in the stakeholder and takeover debate generally array themselves into two distinct camps: one, which views any judicial or legislative attempt to protect stakeholders from harms not explicitly prohibited by corporate contracts as anathema ('non-protectionists'), and the other, which regards corporate responsibility for stakeholder harms as an innate and natural feature of the system of modern corporate governance ('protectionists'). In a perceptive article, Romano attributes part of the differences among scholars on divisive issues of corporate law to the starkly divergent normative beliefs that underlie each side. For non-protectionists, the underlying normative framework is individualistic liberalism, whereas for protectionists, it is usually communitarianism. Given the gulf that divides these underlying normative views, the hope for a principled and durable resolution to the stakeholder debate is indeed dim.

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STAKEHOLDERS AND TAKEOVERS: CAN CONTRACTARIANISM BE COMPASSIONATE?†

The issue of what, if any, purchase non-shareholder corporate constituencies (that is, employees, creditors, suppliers, customers, and communities) should have on the discretionary decisions of corporate management has proved to be one of the most durable, if not vexing, issues in modern corporate scholarship.[1] Most recently, the issue has resurfaced in the context of the takeover wave of the 1980s, particularly during the latter part of the decade when control transactions became associated with high levels of leverage.[2] At core, stakeholder advocates were riveted by the asymmetries involved in change-of-control transactions.[3] While target shareholders earned consistent and sizeable returns from these transactions, stakeholders were left in the cold. Indeed, in some cases, control transactions were thought to be capable of inflicting highly focused losses on stakeholders.[4] So severe were these losses that some commentators

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1 See the famous exchange between Merrick Dodd and Adolf Berle: M. Dodd 'For Whom Are Corporate Managers Trustees?' (1932) 45 *Harv. LR* 1145 and A. Berle 'For Whom Corporate Managers Are Trustees: A Note' (1932) ibid. 1365.

2 A useful review of the data mapping the incidence of mergers and acquisition activity is: R. Khemani 'Recent Trends in Merger and Acquisition Activity in Canada and Selected Countries' in L. Waverman (ed.) *Corporate Globalization Through Mergers and Acquisitions* (Calgary: University of Calgary Press 1991).

3 Recently, the significance of stakeholder interests has been given belated, though not inconsiderable, recognition in the form of anti-takeover amendments to American state corporate statutes, which have allowed and, in some cases, required, corporate directors to consider the effects of mergers and acquisitions on non-shareholder constituencies. (For a review of the effect of state anti-takeover statutes on shareholder welfare, see R. Romano 'The Political Economy of Takeover Statutes' (1987) 73 *Va. LR* 111 and 'The Future of Hostile Takeovers: Legislation and Public Opinion' (1988) 57 *U. Cin. LR* 457).

4 In 1987, for instance, the AFL-CIO claimed that mergers and acquisitions activity resulted in the loss of over 500,000 jobs. (Hostile Takeovers: Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, 100th Cong., 1st Sess. 262, 4 March 1987, statement of Thomas P. Donahue, secretary treasurer of the AFL-CIO). See also M. Lipton 'Corporate Governance in an Age of Finance Capitalism' (1987) 136 *U. Penn. LR* 1; D.J. Morrissey 'Safeguarding the Public Interest in Leveraged Buyouts' (1990) 69 *Ore. LR* 47; and W. Proxmire 'What's Right and Wrong About Hostile Takeovers?' (1988) *Wis. LR* 353.

were led to conclude it was the gains from opportunistic breaching of stakeholder contracts that motivated the transactions in the first place.[5]

As in the past, participants in the stakeholder and takeover debate generally array themselves into two distinct camps: one, which views any judicial or legislative attempt to protect stakeholders from harms not explicitly prohibited by corporate contracts as anathema ('non-protectionists'), and the other, which regards corporate responsibility for stakeholder harms as an innate and natural feature of the system of modern corporate governance ('protectionists'). In a perceptive article, Romano attributes part of the differences among scholars on divisive issues of corporate law to the starkly divergent normative beliefs that underlie each side.[6] For non-protectionists, the underlying normative framework is individualistic liberalism, whereas for protectionists, it is usually communitarianism. Given the gulf that divides these underlying normative views, the hope for a principled and durable resolution to the stakeholder debate is indeed dim.

Recently, a small group of scholars working within the framework of law and economics (Coffee,[7] Shleifer, and Summers[8]) has attempted to bridge the chasm that separates the protectionist and non-protectionist positions by advancing a rationale for the protection of stakeholder interests on a takeover event that is based on implicit contract obligations. The genius of the implicit contract rationale is that it endorses the protectionists' claim for broad, humane assistance to stakeholders, but does so on the basis of the non-protectionists' autonomy-based contractarian paradigm. Equally important, the implicit contract rationale furnishes grounds for conferring special treatment on stakeholder harms in the takeover context.

Nevertheless, despite these virtues, close examination of the implicit contract rationale reveals that it is plagued by several serious infirmities, which undermine the potency and scope of the claim it can make in favour of providing distinctive relief to stakeholders on a takeover transaction. The most serious defect is the assumption that takeovers constitute a unique threat to stakeholder interests. As I will argue below,

5 See section II below.

6 R. Romano 'Metapolitics and Corporate Law Reform' (1984) 36 *Stan. LR* 923

7 J. Coffee 'Shareholders versus Managers: The Strain in the Corporate Web' (1986) 85 *Mich. LR* 1; 'The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders, and Bust-Ups' (1988) *Wis. LR* 435; 'Unstable Coalitions: Corporate Governance as a Multi-Player Game' (1990) 78 *Georgetown LJ* 1495

8 A. Shleifer and L. Summers 'Breach of Trust in Hostile Takeovers' in A. Auerbach *Corporate Takeovers: Causes and Consequences* (Chicago University Chicago Press 1988)

for most change-of-control transactions, this assumption lacks solid foundation. Ironically, despite the expectation that the implicit contract hypothesis would buttress efforts aimed at assisting stakeholders, the sad fact is that the rationale has obscured both an appreciation of how pervasive many of the problems occasioned by corporate restructuring are, as well as the broad range of instruments that can be used to address the harms suffered by the victims of economic change. Instead of invoking rationales for protection that are based on opportunistic cheating, a preferable way of thinking about stakeholder injury is through the prism of contractual failure, here the inability of parties to foresee future risks. So doing does more than merely provide greater conceptual clarity to the problem of stakeholder harm – it remits the problem to the realm of hypothetical bargains and opens the way for principled governmental intervention. I argue that this approach is desirable as, contrary to the antipathy to government intervention voiced by some law and economics scholars, state intervention expands the range and effectiveness of instruments that can be used to protect stakeholders and improve societal welfare.

I *The form and extent of stakeholder losses*

Can takeover activity harm stakeholders? As a theoretical matter, there is no question that control transactions possess the potential to inflict *losses* on stakeholders.[9] These losses range from a loss of jobs for workers to a loss in financial investments of creditors. The severity of losses sustained by stakeholders following a change-of-control transaction is a function of several factors, including the competitive vigour of applicable markets, the scope and magnitude of the severance, and the degree of asset-specific investment that parties have made in expectation of the continued existence of the relationship. Each of these factors will be considered below in the context of identifiable stakeholder groups.

9 In this discussion, I focus on losses as opposed to harms. My point in contrasting losses with harms is straightforward. Before considering the issue of whether stakeholders did or did not assume the risk of losses through ex ante contracting, and whether the corporation (or its shareholders) opportunistically exploited whatever allocation of risk was agreed to, I want first to determine whether change-of-control transactions are in any way associated with systematic losses to stakeholders. In this vein, my argument allows that stakeholders may well suffer losses from control transactions, though these losses may not result from morally blameworthy conduct of another party or from some infirmity in the contracting environment.

EMLOYEES

Consider first the case of a worker suffering a job loss following a merger or acquisition transaction. If it is assumed that the displaced employee was earning a wage equivalent to her marginal product prior to severance, that labour markets are perfectly competitive in the region in which she is located, and that her layoff has not been accompanied by massive layoffs that depress local market wages, then it can be seen that the costs of dislocation will be relatively trivial. By incurring search and retraining costs, the displaced employee should be able to secure comparable employment with a new local employer within a relatively short time. To the extent that losses are sustained in this setting, they are made up of the difference between the present value of the stream of future income receipts from the old employer and the present value of the adjusted stream of future earnings from a new employer, taking into consideration any severance benefits and out-of-pocket adjustment costs. In a setting of rapid re-employment, it is unlikely that the worker will suffer losses on her housing investment. Nor should she suffer losses of a psychic nature related to severed family or community ties, as there would be no need for her to move.

Once these assumptions respecting the operation of the local labour market are relaxed, however, the potential for severance to inflict serious losses on labour is enhanced. For instance, if local markets are beset by massive layoffs, then displaced workers searching for new employment will find that the market clearing price for their labour services has been reduced, causing losses in expected lifetime earnings. These losses reflect not merely the losses on expected income tied to the performance of future services, but include losses on expected compensation for services previously performed for the employer. Deferred compensation arrangements are used as a means of bonding investments by employers in firm-specific human capital.[10] These investments allow employers to increase the marginal productivity of their workforce by supporting the development of firm-specific labour skills. Because of the danger that workers will leave an employer before investment in skills development is recouped, workers will bond their commitment to the firm by agreeing to accept wages below their marginal productivity today for wages in excess of their marginal productivity tomorrow. Since premature defection would jeopardize the ability of workers to gain deferred

10 Deferred compensation arrangements and their impact on collective bargaining and labour law are discussed by Wachter and Cohen 'The Law and Economics of Collective Bargaining: An Introduction and Application to the Problems of Subcontracting, Partial Closure, and Relocation' (1988) 136 *U. Penn. LR* 1349.

compensation, they will be loath to leave their employer prior to the full recovery of these deferred sums.

The predictable effect of a severe and unanticipated contraction in the level of expected lifetime earnings on workers and their families may be devastating. To start, a worker may be forced to default on long-term credit obligations such as mortgages and car loans, which, in turn, may result in the disposal of these secured assets at fire-sale prices, quickly depleting the worker's long-term investments. In cases where desirable employment opportunities can only be obtained by moving from the community, the worker will also bear sundry mobility costs. These costs may be both monetary (moving costs, various transaction costs involved in selling existing houses and buying new ones) and non-monetary (psychic costs that result from severed community and family ties).

All of these costs are magnified in the event that labour market rigidities, that is, an unwillingness on the part of workers to accept offers of employment at rates below those obtained from a previous employer, force workers to endure protracted spells of unemployment. Not surprisingly, as the period of unemployment lengthens, the differential between pre-layoff earnings and post-layoff receipts widens. This differential will be exacerbated by the termination of severance and unemployment benefits from the corporation and the state. Following in train, the more serious the loss in future expected earnings, the greater the likelihood of losses on housing and other investments.[11] And, most tragically, as these costs increase in severity, the prospect of family breakdown, mental collapse, criminal violence, and suicide becomes more likely.[12]

Empirical studies investigating the effect of mergers and acquisitions on labour, however, do not provide unequivocal support for the claim that employees *actually do* experience losses on a merger or acquisition event. Brown and Medoff examined employment and wage data on over 200,000 Michigan firms over a 26-month period and found that, although mergers were associated with wage declines of 4 per cent, employment in these same firms actually increased by 2 per cent. Conversely, asset-only acquisitions were associated with employment

11 For instance, Shleifer and Summers, supra note 8, 50–1, report that the takeover of Youngstown Sheet and Tube resulted in the loss of 6,000 jobs between 1977 and 1979. Personal bankruptcies rose from 769 in 1977 to 1948 in 1981. And, the value of housing in a one-year period dropped by 23 per cent, generating a communitywide loss in housing investment from the takeover of $1 billion.

12 See B. Bluestone 'In Support of the Deindustrialization Thesis' in P. Staudohar and H. Brown *Deindustrialization and Plant Closure* (Lexington, Mass.: Lexington Books 1987).

reductions of 5 per cent but with wage increases of 5 per cent.[13] The results led the researchers to conclude that 'the common public perception that acquisitions provide the occasion to slash wages and employment finds little support.'[14] Similar results were reported by Yago[15] and by Rossett.[16] Interestingly, to the extent that job losses are experienced by workers following an ownership change, these losses are disproportionately concentrated at the level of non-production workers.[17]

13 C. Brown and J. Medoff 'The Impact of Firm Acquisitions on Labor' in Auerbach, supra note 8

14 Brown and Medoff, supra, 23. Support for the claim that mergers do not result in across-the-board wage reductions for employees is furnished by Fust and Peoples 'Merger Activity and Wage Levels in U.S. Manufacturing' (1989) 10 *J. of Labour Res.* 183. By examining 1981 micro data, the researchers found that, while some forms of merger activity, for example, conglomerate mergers, resulted in wage reductions for workers in the affected industry, most mergers (horizontal, vertical, or product extension mergers) resulted in increases in the wages of workers employed in the affected industry.

15 G. Yago *Junk Bonds: How High Yield Securities Restructured Corporate America* (New York: Oxford University Press 1991) chapter 7. Yago examined the correlation between layoffs and leveraged buyouts (LBOs) in the course of reviewing the effects of 43 large LBO transactions concluded between 1984 and 1986. He found that 'on an average means basis, LBO firms ... reversed patterns of job loss prior to ownership change and increased employment after the buyouts' (at 135). These results are consistent with earlier work done by Yago and Stevenson 'Employment Impacts of Mergers and Acquisitions' Working Paper, Economic Research Bureau, W. Averell Harriman School for Management and Policy, State University of New York at Stony Brook (1987). They are also consistent with studies undertaken by the Bureau of Labor Statistics (1989) (cited in Yago at 136), which found that of 2,020 large plant closings and layoffs in 29 states, only 6.6 per cent of the total jobs lost could be attributed to the ownership change. In large part, employment increases are related to systematic increases in productivity in the post-LBO period, as measured by input-output analysis. (Yago found that, in the period 1981 to 1986, the cumulative productivity growth of plants involved in LBOs was 2.8 per cent higher than of plants not involved in LBOs (at 163)).

16 Rossett analysed the effects of mergers and acquisitions on union wage concessions following an ownership change, and observed that post-acquisition wage changes ranged from –0.6 per cent to +0.3 per cent. This led Rossett to conclude that the wage effects of mergers and acquisitions activity pale in comparison with the benefits accruing to shareholders, as measured by econometric event studies. Under the most favourable assumptions to the stakeholder harm thesis, ownership changes result in worker wage losses equal to 12 per cent of the combined premium. But, on assumptions least favourable to the harm thesis, ownership changes result in an increase equal to 4 per cent of the combined premiums. Rossett 'Do Union Wage Concessions Explain Takeover Premiums? Evidence on Contract Wages' NBER Working Paper no. 3187 (1989)

17 S. Bhagat, A. Shleifer, and R. Vishny studied 62 hostile takeover contests between 1984 and 1986 and found that for those firms laying off employees (26 of 62 firms in the sample), most of the savings in labour costs were derived from white-collar layoffs (emanating from head office consolidations). Interestingly, the comparatively higher costs of white-collar (as opposed to blue-collar) layoffs were incurred by laying off fewer workers. The reason for the higher total costs of these layoffs

Apart from the studies evaluating labour cost savings in terms of wage and employment reductions, other analysts have focused on the effect of mergers and acquisitions on loss of other labour benefits. For instance, Pontiff, Shleifer, and Weisbach examined reversion of excess pension fund assets both before and after a takeover, and found that these reversions occur more frequently after an acquisition event than before, and that there is a higher incidence of pension fund reversions following hostile as opposed to friendly mergers and acquisitions.[18] However, the researchers found that reversions occur relatively infrequently, that is, in only 14 per cent of all takeovers, and when they do occur, they can account for only 10 per cent to 13 per cent of takeover premiums.

SUPPLIERS

Suppliers' concerns with a change-of-control transaction arise from the prospect that corporations undergoing such transactions will terminate contracts for the supply of goods and services. The termination or non-renewal of supply contracts may inflict losses on suppliers resulting from non-recoverable asset-specific investments made in express anticipation of a long-term relationship with a particular purchaser. In extreme cases, these losses may be severe enough to force the supplier into bankruptcy, generating loss of employment for workers employed by the supplier, the bankruptcy of other suppliers upon whom the initial supplier was dependent for intermediate goods, and, of course, the layoff of workers employed by these other suppliers. Once individuals suffer bankruptcy or unemployment, they are vulnerable to many of the harms that were discussed in relation to workers laid off directly by companies.

CUSTOMERS

The primary threat to customer interests from a merger or acquisition transaction is that an acquiror will attempt to rationalize production

derives from the higher wages the employees received prior to termination: 'Hostile Takeovers in the 1980s: The Return to Corporate Specialization' in M.N. Bailey and Clifford Winston (eds) *Brookings Papers on Economic Activity: Microeconomics 1990* (Washington, DC: Brookings Institution) 1–72. F. Lichtenberg and D. Siegel also found that employment and wage losses were almost three times more significant in administration and headquarters staff (middle management and white-collar workers) than in production units (blue-collar workers), causing a reduction in the ratio of non-production to production workers of 11.2 per cent in firms experiencing an ownership change compared with firms not so involved. Lichtenberg and Siegel 'The Effect of Takeovers on the Employment and Wages of Central Office and Other Personnel' First Boston Working Paper Series, Graduate School of Business, Columbia University, FB-89-05 (January 1989)

18 J. Pontiff, A. Shleifer, and M. Weisbach 'Reversions of Excess Pension Assets After Takeovers' (1990) 21 *Rand J. Econ.* 600

between existing and acquired plants by terminating certain product lines. If the terminated product line includes expensive goods having a lengthy remaining expected life, then it is possible that customers having purchased these goods will suffer from reduced market values. The reduction in value results from difficulties purchasers may have in obtaining replacement parts or in accessing competent post-purchase service for these goods. Predictably, the severity of these problems turns on the distinctiveness of the good in question and on the capacity of competitive suppliers to offer adequate post-purchase support. If the goods are not manufactured through unique production processes and are not protected through elaborate intellectual property safeguards, then it will be easier for a competitor to supply customized parts and services.

Yet there is nothing inevitable about product support terminations following a change-of-control transaction. Even if there is no robust market in after-purchase parts and services, the acquiring firm may perceive that it can earn a normal or, perhaps, even a supra-normal return on replacement parts and services. And, in the event that a manufacturer faces economic losses on the continuation of after-purchase support for customers, strong incentives may still operate to maintain an inventory in these goods, as the failure to do so may compromise the value of fixed investments in reputational capital.[19] This concern will be greatest for acquirors who wish to lure customers to product lines that are substitutes for the terminated good.

COMMUNITIES

The losses faced by communities from change-of-control transactions are the direct result of the harms suffered by workers and suppliers residing in the community. As bankruptcies and layoffs increase, the local tax base of the community will contract correspondingly. At the same time, through increased utilization of publicly funded support programmes, the community's overall expenditures will increase. This budgetary pressure may result in cuts to so-called non-essential services, which will reduce the quality of community life. As the number of layoffs and bankruptcies increases, workers who are the lifeblood of the community – younger, more mobile workers – will recognize the limited opportunities for future prosperity in the community and will migrate to other communities, leaving behind family, friends, and co-workers in the process. If this haemorrhaging goes uncontrolled, the community will be

19 This point is discussed more extensively in secton II below.

left with non-recoverable infrastructural investments that will be under-utilized or abandoned altogether.[20]

CREDITORS

Finally, for creditors, the loss from a takeover transaction may come in the form of wealth losses from depreciated debt. Credit devaluation results from any change in circumstances that increases the risk that the debtor corporation will default on its obligation to the creditor or that there will be insufficient assets available to satisfy the debt owed to creditors on a default event. Assuming efficient and liquid capital markets, any increase in risk will be reflected in an increase in the size of the discount necessary to entice other individuals to purchase the debt instrument. As the discount increases in value, so too does the loss to creditor wealth.

The data linking change-of-control transactions with systematic losses to creditor interests are, like those in the case of employees, somewhat equivocal. On the one hand, early studies seem to indicate that merger and acquisition transactions do not have a deleterious impact on creditor wealth. Kim and McConnell studied monthly returns to non-convertible bondholders between 1960 and 1973 for 20 acquiror firms and 19 acquired firms, and found that there were no significant gains or losses for either group upon an acquisition event.[21] On the other hand, more recent studies, which parallel the rise in more highly leveraged transactions, appear to support the claim that mergers and acquisitions can impose losses on creditors from defeated expectations.[22] For instance,

20 This infrastructure takes the form of investment tied directly (roads, utility services, etc.) and indirectly (community recreational centres, schools, etc.) to the closed plant.

21 Kim and McConnell 'Corporate Mergers and the Co-Insurance of Corporate Debt' (1977) 32 *J. Fin.* 349. The methodology used by Kim and McConnell to evaluate creditor losses has been criticized by Asquith and Kim on the basis of the former's reliance on monthly rather than daily returns data and merger consummation rather than announcement dates (Asquith and Kim 'The Impact of Merger Bids on the Participating Firms' Security Holders' (1982) 37 *J. Fin.* 1209). Nevertheless, after correcting for these defects, Asquith and Kim reported results that paralleled Kim and McConnell's. That is, over the period 1960 to 1978, the researchers found no abnormal returns to bondholders in either acquiror or acquired firms. These results were echoed by Dennis and McConnell in a study of 132 transactions occurring in the period 1963 to 1980, which found that there were no losses to bondholders from merger activity. In fact, the researchers found that some classes of senior security holders and bondholders gained from a merger. Dennis and McConnell 'Corporate Mergers and Security Returns' (1986) 16 *J. Fin. Econ.* 143

22 In this respect, L. Crabbe in 'Event Risk: An Analysis of Losses to Bondholders and "Super Poison Put" Bond Covenants' (1991) 46 *J. Fin.* 689 observes that the losses creditors suffered on the announcement of the mammoth RJR Nabisco leveraged

Amihud found that of the 15 large LBOs he examined, the outstanding debt of 8 out of 15 firms was downgraded, while the debt of the remaining 7 was either placed on credit watch or considered for downgrading.[23] Lehn and Poulsen have also found that creditors can suffer losses from LBOs.[24]

buyout ($1 billion) constituted only a small fraction of the gains accruing to target shareholders ($12 billion).

23 Y. Amihud 'Leveraged Management Buyouts and Shareholders' Wealth' in Amihud, *Leveraged Management Buyouts: Causes and Consequences* (1989) 11–2. In a similar vein, see Crabbe, supra. In this study, bondholders were found to have suffered losses of 12.33 per cent in the value of their bonds following a capital restructuring. However, these results are only crudely applied in this setting as there is no necessary link between capital restructuring and merger and acquisition activity.

24 Lehn and Poulsen 'Leveraged Buyouts: Wealth Created or Wealth Redistributed?' in Weidenbaum and Chilton *Public Policy Toward Corporate Takeovers* (1988). From a sample of 92 LBOs in the period 1980 to 1984, they found that redistribution of wealth from bondholders to shareholders could not be an important motivation for these transactions as only 24 of the 92 firms involved in an LBO had outstanding debt. However, examination of trading data around the announcement date showed that bond prices in these firms *declined* by an average of 1.42 per cent. Significantly, when the effect of these transactions is disaggregated by bond type – convertible or non-convertible – significant differences can be observed in the experience of different debt classes. That is, while the price of non-convertible bonds *decreased* by 2.46 per cent on announcement of an LBO, the price of a convertible bond *increased* by 0.49 per cent around announcement. Even more strikingly, the price of outstanding preferred shares (not market adjusted) increased by an average of 23.37 per cent on announcement, with the most notable increases experienced by three non-convertible issues (40.67 per cent). Differential effects on creditors depending on conversion privileges have also been observed by Marais, Schipper, and Smith 'Wealth Effects of Going Private for Senior Securities' (1989) 23 *J. Fin.* 155. The authors evaluated the effect on creditors from *going private* transactions in the period 1974 to 1985 and found that although buyouts generated increased returns to convertible bondholders, buyouts exerted no effect whatsoever on non-convertible bondholders. They also found that 'there are only 19 buyouts, which together account for less than 2% of the total dollar gains to stockholders, for which plausible debtholder losses – on the order of 10% of book value – can account fully for stockholder gains.' The difference in the experience of convertible and non-convertible creditors in a merger or acquisition event reflects the role that these provisions play in allowing creditors to participate in some of the upside gains from a merger or acquisition transaction, and in overcoming the losses these individuals would suffer were they confined solely to an interest in the debt of the corporation. These privileges can, therefore, be viewed as a device for attenuating endemic inter-investor agency conflicts. The divergence in interests between shareholders and creditors in responding to certain types of proposed transactions (the 'agency costs of debt') is discussed in Barnea, Haugen, and Senbet *Agency Problems and Financial Contracting* (Englewood Cliffs, NJ: Prentice Hall 1985) chapters 3 and 4; and in Klein and Coffee *Business Organizations and Finance: Legal and Economic Principles* (4th ed.) (Westbury, NY: Foundation Press 1990) chapter 4.

CONCLUSION

This discussion identified the various losses that stakeholders could conceivably suffer from a takeover event, relying on empirical data wherever possible to determine whether, in fact, stakeholders do systematically bear these losses. Although the data are paltry, they do not furnish support for the conclusion that, at least insofar as the interests of employees and creditors are concerned (the only two stakeholder groups for which robust data are available), stakeholders suffer certain injury following every change-of-control transaction. And although the data show that losses are experienced by stakeholders, they are not nearly large enough to account for the gains to shareholders from a takeover transaction.[25] In other words, the primary motivation for this activity does not appear to be redistributional. Nevertheless, this survey does show that, in some circumstances, some classes of stakeholders can experience loss from a change-of-control transaction.[26] In the case of labour, employees have sometimes lost their jobs and endured wage and pension benefit reductions. In the case of creditors, wealth losses from merger or acquisition transactions have become more common in the last decade, but appear to be limited to creditors who failed to insist that conversion or redemption privileges be included in their debt contracts. On the basis of these data, it can be assumed that other stakeholders, that is, suppliers, customers, and communities, may also suffer some degree of loss, though again, it is highly unlikely that these harms are large enough to account for all the gains of a transaction.

II *Contract, community, and the stakeholder debate*

As the discussion in the previous section shows, the causal relationship between merger and acquisition transactions and losses to stakeholders is far from clear. These findings place a special burden on proponents of

25 On average, the shares of target firms post significant gains (20 to 30 per cent) upon the announcement of a merger or acquisition transaction. The gains to the shareholders of acquiring firms, however, may be slightly negative or zero. See G. Jarrell, J. Brickley, and J. Netter 'The Market For Corporate Control: The Empirical Evidence Since 1980' (Winter 1988) 2 *J. Econ. Persp.* 49. The size of the gains to target shareholders creates a strong presumption in favour of the wealth-maximizing character of these transactions. For a comprehensive discussion of the empirical literature respecting takeovers see R. Romano 'A Guide to Takeovers: Theory, Evidence, and Regulation' (1992) 9 *Yale J. on Regulation* 119.

26 See general discussion in G. Calabresi 'The Pointlessness of Pareto: Carrying Coase Further' (1991) 100 *Yale LJ* 1211 (movement of Pareto frontier outward not necessarily at odds with shifts along the frontier that redistribute wealth from one societal group to another).

specialized protection for stakeholders in the takeover context. In this section, the rationale for stakeholder protection following a change of control is examined. By and large, the debate over the appropriate protection for stakeholders has taken place between contractarian non-protectionists and communitarian protectionists. Both positions are defective for their dependence on highly contestable normative and empirical claims. Reflecting dissatisfaction with these polar positions, a group of scholars working within the law and economics tradition have offered a middle ground, based on implicit contractual analysis, that would appear to support protection for virtually all corporate stakeholders on a change-of-control transaction. However, as the discussion will show, for a number of reasons this position too is untenable.

CONTRACTARIAN NON-PROTECTIONISTS

The argument used by non-protectionists against the extension of any assistance whatsoever to stakeholders is based on normative contractarian analysis.[27] For contractarians, the sanctity of contract is based on its autonomy and welfare-enhancing values.[28] Because individuals have consented to undertake some joint activity, that arrangement must, by definition, make both parties better off, thereby making society better off as a consequence.[29] Nevertheless, as Trebilcock has persuasively argued, even the most strident contractarians admit that the claim in favour of the value of contract is predicated on several crucial assumptions, the absence of which may cast considerable doubt on the central welfare and autonomy claims made for contract, and may even support quite expansive state intervention.[30] However, most non-protectionists neglect these qualifications in favour of a fairly narrow and rather impoverished view of contractarianism. And, once this foundation is embraced, the denial of any protection to stakeholders follows quite naturally.

27 The most thoughtful arguments from this perspective are: W. Carney 'Does Defining Constituencies Matter?' (1990) 59 *Cin. LR* 385; J. Macey 'Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes' (1989) *Duke LJ* 173; and 'An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties' (1991) 21 *Stetson LR* 23.

28 For a general introduction to contractarian analysis see K. Lane Scheppele and J. Waldron 'Contractarian Methods in Political and Legal Evaluation' (1991) 3 *Yale J. of Law & Humanities* 195 (contractarian analysis attractive for its premium on freedom and consent, as well as on equality and impartiality).

29 See, for instance, Milton Friedman *Capitalism and Freedom* (Chicago: University of Chicago Press 1962) 13.

30 Michael J. Trebilcock *An Exploration of the Limits of Freedom of Contract* (Cambridge, Mass.: Harvard University Press 1993)

In the takeover context, the normative commitment to narrow contractarianism supports the following claims:

1 stakeholders are seized of full information at the time of contract formation, and, therefore, are able to make accurate predictions of the welfare consequences of the agreement;
2 stakeholders do not suffer any disability in their bargaining with the corporation; that is, in combination with (1), their agreements are truly voluntary;
3 since stakeholders are able to contract with the corporation, external effects do not furnish a basis for interference in the contracts concluded;
4 in view of the institutionalized obligation of managers to maximize the welfare of shareholders (the principals of the corporation), stakeholders will recognize that managerial discretion cannot be relied on to protect their interests, and they will rationally demand explicit ex ante protection for future harms with which they are particularly concerned;
5 if protection for some possible harm is not expressly provided for in the stakeholder's written contract with the corporation, then it must mean that the stakeholder assumed the risk of the harm, and has received some compensating benefit (wage or benefit differential);
6 to the extent that some future contingency having dire welfare consequences for either party is not anticipated at the time of contract formation, stakeholders and the corporation can adjust their relationship to account for this contingency in their future bargaining; and
7 in contrast to outcomes generated through private ordering, government intervention that is designed to protect stakeholders will invariably make the parties worse off as it constrains and distorts the dynamics of private bargaining.

In tandem, these claims create an impregnable barrier to intervention designed to improve the lot of stakeholders on the occurrence of a takeover, or indeed any other event that precipitates fundamental, and potentially dislocative, corporate restructuring.[31] Nevertheless, even

31 Since these events have been fully anticipated and contracted for in advance of their occurrence by the parties, any intervention in the domain of private ordering by, for instance, requiring corporations to abstain from control changes or compensating stakeholders in the event that a change occurs, will confer ill-deserved windfall gains and losses on stakeholders and shareholders, respectively. Further, the enforcement uncertainties created by government intervention will impair the ability of other parties to order their affairs in an optimal fashion.

cursory examination of the claims embedded in this non-protectionist position reveal their highly problematic character. The environment for stakeholder–corporation bargaining may be plagued by serious infirmities. Information regarding the likelihood and magnitude of certain events may be unavailable or mistaken.[32] Endemic agency problems may hobble the capacity of various stakeholder groups, for example, organized and non-organized labour, to negotiate effectively with management.[33] These problems may be only somewhat mitigated by market benchmarks created by the interaction of marginal suppliers and consumers.[34] Further, as Stone has shown, certain legal infirmities may impair the capacity of stakeholders to enforce corporate undertakings.[35]

An even more tenuous plank in the non-protectionist argument is the claim that, although stakeholders may suffer transitional harm from unforeseeable risks, they can correct for these mistakes in their future bargaining with the corporation. For many stakeholders, however, the transitional loss involves a permanent job loss that deprives them of the ability to 'correct' mistaken bargains in future rounds of negotiations. And even for those stakeholders who have the opportunity to re-bargain with the corporation, the occurrence of the loss may shift the balance of power between the contracting parties in favour of the corporation, undermining the stakeholder's ability to extract ex post compensation for losses.[36]

32 For instance, the nature and magnitude of the takeover wave of the 1980s may not have been anticipated by either stakeholders or the corporation. Alternatively, the corporation may have had 'better' information than stakeholders regarding both the likelihood and consequences to stakeholders of a takeover, which it failed to disseminate to stakeholders at the time of contract.

33 If the number of similarly situated stakeholders in a given corporation is large, stakeholders may find themselves unable to coordinate effectively in their negotiations with management because of free rider and other collective action problems. And, to the extent that the interests of appointed agents of stakeholders are not perfectly aligned with those of their principals, delegation will not solve coordination problems.

34 That is, to the extent that the markets generating these outcomes are themselves plagued by structural defects, such as the adjustment rigidities normally found in labour markets, the quality of their outcomes will be suspect.

35 Katherine Van Wezel Stone 'Employees as Stakeholders Under Nonshareholder Constituency Statutes' (1991) 21 *Stetson LR* 45

36 Quite simply, once a corporation has decided to reduce its production capacity through either layoffs or plant closures, the bargaining climate between the union and management will be altered in a way that is inimical to labour's interests. Unlike the forward-looking nature of bargaining at the time that a collective agreement is negotiated, the decision to reduce production activity marks a termination of the commitment of management to the maintenance of a long-term relationship and the emergence of debilitating 'final period' problems. In this setting, the bargaining power of labour will be severely eroded, rendering the like-

A final difficulty with the strong form of the non-protectionist claim is its innate antipathy to government intervention. There is no intrinsic reason why certain forms of government intervention cannot in some circumstances improve the opportunity set open to individual actors, rather than constraining it. It may well be that government intervention is better able to render credible commitments to stakeholders than can the companies who employ them – particularly when the risks of bankruptcy are considered. Moreover, governments may have certain comparative advantages over the private sector emanating from economies of scale and scope or from more effective enforcement powers. In these terms, government assurances that certain forms of assistance will be provided to stakeholders may make them more willing to assume the risks of loss than they would in their absence, thereby expanding the space for private bargaining.[37]

COMMUNITARIAN PROTECTIONISTS

In contrast to non-protectionists, communitarian protectionists expressly disavow any reliance on contractarian norms, preferring instead a communitarian vision of the good society. This claim has been given its most cogent expression by Singer in an article that examines the plight of employees following a plant closing.[38] For Singer, contractarian principles are defective for their reliance on erroneous and contestable assumptions about human behaviour and societal goals (possessive individualism, autonomy, freedom of contract, and the public/private distinction). In lieu of contractarian reasoning, Singer argues for protection to stakeholders, particularly employees, on the basis of a new 'social vision of property law [which] will centre on the image of *protecting reliance on relationships constituting common enterprises*.'[39] Singer draws on an admixture of political, economic, legal, and moral arguments to support his claim that society needs to 'do something about a concrete, historically contingent problem.'[40] That 'something' involves employee severance payments, advanced notice, rights of first refusal of a plant with just compensation, supervised negotiation and forced sale of plants, employee rights of entry for waste, and damages for reliance.

lihood that management will make meaningful concessions to employees relatively remote.

37 The comparative attributes of government versus private provision of services are canvassed in R. Howse 'Retrenchment, Reform or Revolution: The Shift to Incentives and the Future of the Regulatory State' (1993) 31 *Alberta LR* 455.

38 Joseph William Singer 'The Reliance Interest in Property' (1988) 40 *Stan. LR* 611

39 Ibid. 661

40 Ibid. 643

Despite its more humane approach to the plant closing problem, Singer's vision is flawed for several major reasons. First, like other contract relationalists, Singer argues that corporations (and society) owe stakeholders certain duties, but never clearly identifies whence those duties derive. Singer's energies are concentrated on establishing that a relationship between stakeholders and the corporation exist because, once he does so, the content of obligation flows logically from the fact of the relationship.[41] That is, actual content conforms to a standard prototype that emphasizes sharing, distributional equity, participation, and preservation of the relationship.[42] These values appear to inform most, if not all, stakeholder relationships to the corporation. However, the stark variance in the character of stakeholder relationships within the corporation, particularly in terms of risk preferences and risk-bearing capacities, makes it implausible that all stakeholders either desire or expect to vindicate these values.

Second, though Singer places a heavy discount on the currency of contractarian reasoning, in the end his methodology resonates with the logic of bargaining and ex ante expectations. For instance, in determining the content of the responsibility of the corporation to employees for plant closings, Singer argues for a broad relational view of the interaction between stakeholders and the corporation that is expressly dependent upon factors such as expectations, the terms of explicit agreements, parties' reliance, past contributions of effort to the joint enterprise, and the consequences of narrowing and broadening corporation/employee obligations.[43] However, despite this cautious nod to ex ante bargaining, Singer never draws the inevitable implication – that for a legitimate reliance interest to develop, it must dovetail with the actual intentions of the parties and be subject to notions of reasonableness. And once intentions are allowed, there is little reason to believe that all stakeholders will import the same values or expectations into their relationships with the corporation.

41 Ibid. 653

42 The relational contract paradigm is developed in Ian R. Macneil 'Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law' (1978) 72 *Nw. U. LR* 854 and 'Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus"' (1981) 75 *Nw. U. LR* 1018; Stewart Macaulay 'Elegant Models, Empirical Pictures, and the Complexities of Contract' (1977) 11 *Law & Soc. Rev.* 507. With respect to the values that should be used in interpreting relational contracts see Macneil, who argues that as relations expand, they take on 'more and more the characteristics of mini-societies and mini-states' and, hence, the invocation of these broader norms ('Contracts' supra 898).

43 Singer, supra note 38, 653–61

Finally, and related to the last point, Singer's belief that workers and other stakeholders will wish to preserve their working environments at all costs is not at all consonant with the realities of a highly dynamic market environment in which the spectre of competitive, though often tragic, dislocation is an inevitable feature.[44] Though one may not wish to deny the non-instrumental value of workplace participation, the fact remains that participation cannot support the non-economic operation of plants or firms.[45] In this respect, Singer's argument is impervious to the grim, though undeniable, logic that vindication of many of the most humane and laudable goals of the modern social welfare state can only be realized on a foundation of surplus economic wealth created through Schumpeter's process of 'creative destruction.'[46]

IMPLICIT CONTRACTS – THE THIRD WAY

Charting a middle course between the Scylla of unaccommodating contractarianism and the Charybdis of quixotic communitarianism is the implicit contractual analysis. According to its proponents, implicit contractual analysis is able to furnish a rationale for protection of stakeholder interests upon a merger or acquisition event that is based on the parties' actual expectations. Hence, the paradigm's congeniality to both autonomy and welfare-based contractarianism. A further benefit alleged for the implicit contracting model is its ability to explain why change-of-control transactions are qualitatively more destructive to stakeholder interests than are other economic dislocations.

In a series of perceptive articles, John Coffee, for instance, has argued that takeovers, particularly those of the 'bust-up' variety, pose special dangers to stakeholder interests because of the possibilities for opportunistic reneging of implicit contracts. According to Coffee:

> Modern institutional economics views the corporation as a 'nexus of contracts' – a complex institutional mechanism, which is designed, at least in part, to uphold (and thus permit reliance upon) 'implicit contracts' reached between the shareholders and other 'stakeholders' in the corporation (e.g., managers, creditors, employees, and possibly certain suppliers). The nature of these implicit contracts – that is, what is exchanged – can be variously defined ... For present purposes, the differences among these 'implicit contract' theories are of secondary importance, because in common all recognize the possibility that shareholders

44 M. Trebilcock, M. Chandler, and R. Howse *Trade and Transitions* (London: Routledge 1990)

45 Especially in the face of strong countervailing economic pressures

46 R. Daniels and R. Howse 'Reforming the Reform Process: A Critique of Privatization in Central and Eastern Europe' *NY J. of Int. Law & Pol.* (forthcoming)

could opportunistically breach the implicit contract. In so doing, shareholder wealth is increased but social wealth is not.[47]

Once a role for implicit contracts is found to exist, it is but a short step to finding that the asymmetries in the post-transaction welfare of shareholders and stakeholders violate ex ante expectations and therefore support intervention (in the form of non-discrimination rules or sensible side constraints) aimed at distributing the gains of takeovers in a more equitable direction.[48]

The implicit contractual claim in favour of stakeholder protection is not uncontroversial. To succeed, its supporters must first demonstrate that the corporation's shareholders, either explicitly or implicitly, made promises to stakeholders to allow them to share in the gains from a takeover. Having done so, they must then show that these promises were meant to be enforced by legal as opposed to non-legal sanctions. Each of these factors will be considered below.

1. Implicit contracts for gain sharing on a merger or acquisition event

Disregarding the mechanism for enforcement, the claim that shareholders (or their proxies) and stakeholders actually concluded implicit contracts that require gain sharing on a takeover transaction is controversial. However, it is important to be clear about the precise source of controversy. It is not that implicit promises are, as a general matter, implausible in the context of the firm, just that the *precise* promise alleged by the advocates of the implicit contractual paradigm is suspect. After all, given neoclassic economics' reliance on command-based decision-making in explaining the comparative advantage of firms over markets in organizing economic production, it should not be surprising or controversial to expect that shareholders would make implicit promises to stakeholders in exchange for agreement to perform certain tasks or duties.[49]

47 Coffee (1988), supra note 7, 446

48 Ibid. 460

49 Ronald H. Coase 'The Nature of the Firm' (1937) 4 *Economica* 386. Reprinted in Stigler (ed.) *Readings in Price Theory* (1952). Coase argues that the rationale for the firm lies in its superior capacity to economize on the transaction costs of negotiating, drafting, and enforcing discrete contracts for joint economic activity. In place of costly market transactions, the firm organizes transactions by direction or 'command' of the entrepreneur coordinator. The essence of command is the ability of the firm to respond quickly and effectively to changing market conditions. But the willingness of the firm's agents to submit to the command of the firm's entrepreneurial coordinator is not costless; in return for their commitment to follow the direction of management in responding to changing market conditions, agents insist on assurances of fair compensation and effective protection for firm-specific

Otherwise, the benefits of flexible, discretionary management would be lost.[50]

However, having agreed that implicit promises can form an important part of relations within the firm, it remains to be shown what the actual content of that promise is likely to be. For Coffee, the promise is one of gain sharing on a takeover. The difficulty, however, with the gain-sharing claim lies in its wholly unprincipled character. What is it about takeovers, as opposed to a wide range of other economic events that inflict losses on stakeholders, that calls out for special treatment? This question is especially salient when it is understood that the actual harm from a takeover transaction emanates not from a shift in control per se, but from the introduction of fresh or more economically disciplined thinking into the corporation, which, in turn, increases the likelihood that corporate policy will be reoriented in a welfare-maximizing direction.[51] In these terms, the losses that stakeholders are alleged to sustain following a takeover transaction could just as easily have been ushered in by events unrelated to a shift in control, including: the lowering of an external trade barrier, the death or replacement of a chief executive officer, or the leadership of a shareholder activist.

To enthusiasts of the implicit contractarian model, the 'wrong' of takeovers is not that stakeholders lose, but that stakeholders lose while shareholders gain.[52] This asymmetrical sharing of gains and losses explains why implicit contractarians are so critical of takeovers and more resigned to the harms inflicted by a wide range of other dislocative transactions.[53]

investments. These assurances come in the form of either governance or contractual protections.

50 In this respect, the implicit contracting paradigm of organizational economists has much in common with the theory of contract relationalists – both theories are congenial to understandings and expectations that evolve from the implicit conduct of the contracting parties. However, in sharp contrast to relationalists, economists remain narrowly focused on the actual expectations of the parties, and sedulously refuse to incorporate values of solidarity, mutuality, and fairness unless the parties have actually expressed a desire to be bound by them.

51 In these terms, the underlying motive of the takeover casts important light on the nature and magnitude of the shift in post-transactional corporate policy. R. Daniels 'Mergers and Acquisitions and the Public Interest: Don't Shoot the Messenger' in Waverman (ed.) supra note 2.

52 As J. Coffee has stated: '[E]ven if there is no net social loss [from a takeover], any wealth transfer is probably in an anti-egalitarian direction, because employees are losing as shareholders gain.' Coffee (1988), supra note 7, 448

53 Because shareholders suffer along with stakeholders, the latter will be more accepting of their losses and will not have developed any strong expectations of implicit protection.

The claim that shareholders would have promised stakeholders a right to share in the gains of a takeover transaction draws some support from the experimental economics literature. Kahneman, Knetsch, and Thaler, for instance, use household surveys of public opinion to infer rules of market fairness.[54] Lying at the core of community notions of market fairness is the principle of dual entitlement:

> Transactors have an entitlement to the terms of the reference transaction and firms are entitled to their reference profit. A firm is not allowed to increase its profits by arbitrarily violating the entitlement of transactors to the reference price, rent or wage ... When the reference profit of a firm is threatened, however, it may set new terms that protect its profits at the transactors' expense. Market prices, posted prices, and the history of previous transactions between a firm and a transactor can serve as a reference transaction.[55]

Under the 'dual entitlement' theory, takeovers are colourable because shareholders earn windfall returns over the reference price that are not in any way linked to cost increases, while stakeholders are concurrently forced to suffer losses.

Despite its surface plausibility, the normative force of sharing symmetry cracks under close examination. To begin with, the empirical literature canvassed earlier does not support a clear link between shareholder gains and stakeholder losses. If stakeholders lose following a takeover transaction, the loss does not appear to be motivated primarily by redistributive goals. In other words, while shareholders may gain from a takeover, this transactional gain is analytically distinct from the shareholder loss. In most cases, both the shareholders and the stakeholders lost on the investment made in the stakeholders' firm-specific capital. If a corporation is forced to displace a stakeholder whose firm-specific capital has depreciated more quickly than anticipated, this is a loss both for the corporation (that is, shareholders) and the stakeholder. The reason why shareholders gain – despite the loss related to obsolete stakeholder firm-specific capital – is that there are other unrelated gains (synergies, improved management, monopoly profits, tax benefits) from a takeover that are split between acquiring and target shareholders. And

54 D. Kahneman, J. Knetsch, and R. Thaler 'Fairness as a Constraint on Profit Seeking: Entitlements in the Market' (1986) 76 *Am. Econ. Rev.* 728. See also E. Hoffman and M. Spitzer 'Entitlements, Rights, and Fairness: An Experimental Examination of Subjects' Concepts of Distributive Justice' (1985) 14 *J. Leg. Studies* 259 (if subjects perceive no morally justified difference between themselves, they will distribute the surplus from a cooperative game equally, even though a first mover could appropriate most of the surplus from the game).

55 Kahneman et al., supra, 729

since these gains lack any causal nexus to the stakeholder loss, there is no reason to force gain sharing.

Second, even if one assumes that part of the shareholders' gain on a takeover derives from redistributions from stakeholders, it is not at all clear that this situation is in any way distinct from a wide range of other non-control transactions or events that impose losses on stakeholders. Take, for example, the recent wave of massive employee layoffs being undertaken by some of America's leading corporations – layoffs that are, of course, not typically accompanied by any change in control. It is true that shareholder losses are usually the triggering event for a decision by management to rationalize the workforce: witness the recent cases of IBM (65,000 job losses in 1992 and 1993), General Motors (79,000 job losses in 1992 and 1993), and Digital (15,000 job losses in 1993).[56] In this respect, shareholder and stakeholder losses appear to be symmetrical. However, there is no reason why an actual shareholder loss would necessarily have to precede stakeholder losses. Were the management of the company attentive to shareholder interests, one could easily imagine that it would implement extensive rationalization before any loss were experienced by shareholders. And even if shareholder losses do precede rationalization (with attendant job losses), such activity could quickly translate into sizeable shareholder gains, while the losses suffered by stakeholders are of a permanent nature. In these terms, the only real difference between rationalization that occurs in a takeover and non-takeover context may well be the degree of crystallization of shareholder gain: in the takeover setting, it is up-front and visible, whereas in the non-takeover case, it may occur more slowly and is, therefore, less transparent.

A third and final point goes to the actual symmetry in nature of stakeholder and shareholder losses. Even if shareholders suffer losses prior to the implementation of a rationalization programme that will then inflict losses on stakeholders, there is no reason to expect that the losses suffered by each will actually be commensurate with one another. Shareholder losses could be fairly shallow and short-lived, while stakeholder losses are likely to be higher and more protracted. To be a valid criterion for determining the degree of stakeholder protection, it is not sufficient merely to demonstrate that both groups have suffered losses, but that the

56 See *Globe and Mail*, 25 May 1992; *Wall Street Journal*, 1 December 1992; and *Globe and Mail*, 24 July 1992. In a one-week period, four major American companies (Boeing, McDonnell Douglas, United Technologies, and Sears Roebuck) announced job cutbacks affecting close to 100,000 workers. L. Uchitelle 'Stanching the Loss of Good Jobs' *New York Times*, 31 January 1993

losses are actually parallel. Otherwise, management could simply contort accounting data to show a paper loss to shareholders, which would then insulate the company from having to provide any further redress to stakeholders.

This point emerges from a study by D'Angelo and D'Angelo focused on the extensive rationalization programme adopted by the American steel industry in the 1980s.[57] That programme resulted in a 38 per cent reduction in productive capacity, a 62.7 per cent reduction in the number of steelworkers, and a 46.6 per cent reduction in the total wage bill over an eight-year period.[58] Although both shareholders and management endured losses during this period (in the case of shareholders, in the form of dividend cuts and omissions; in the case of managers, salary and bonus reductions), the researchers noted that these losses in no way paralleled the magnitude of the losses (on a pro rata or aggregate basis) suffered by employees. Money saved in dividend cuts, for instance ($262 million), was small in relation to the billions of dollars in labour cost savings achieved during the period.[59] Even more arresting is the fact that to the extent that shareholders claimed to have experienced losses in forgone dividends, these 'losses' may have had little effect on overall shareholder wealth given the possibility of capital gains. The same is true of management. Salary and bonus reductions imposed on management were not consistent during the period, and were usually taken in those years in which company–union negotiations were taking place.

2. Implicit promises enforced by legal sanctions

Even if one assumes that stakeholders actually expected distinctive protection from shareholders on a takeover transaction, the question then emerges as to how that expectation is to be enforced. To enlist the state's assistance in enforcing these implicit promises, stakeholders must demonstrate that the parties relied on legal, as opposed to self-enforcing, non-legal, sanctions.

The role and operation of non-legal sanctions has been closely considered by David Charny.[60] In the tradition of Klein and Leffler[61] and

57 H. D'Angelo and L. D'Angelo 'Union Negotiations and Corporate Policy' (1991) 30 *J. Fin. Econ.* 3

58 Ibid. 13–5

59 Ibid. 29

60 David Charny 'Nonlegal Sanctions in Commercial Relations' (1990) 104 *Harv. LR* 373

61 Klein and Leffler 'The Role of Market Forces in Assuring Contractual Performance' (1981) 89 *J. Pol. Econ.* 615

Williamson,[62] Charny argues that commercial parties utilize a variety of non-legal sanctions to bond non-simultaneous obligations emanating from implicit contractual undertakings. These sanctions are based on the desire of the promisor 'to maintain reputation or profitable relationships, the concern for standing among peers, and the force of conscience.'[63] For Charny, the decision as to whether to bond promises by way of legal or non-legal sanctions is a function of a complex analysis that, inter alia, includes attention to drafting, enforcement, and opportunism costs. If the promisor's obligation, as well as the consequences of breach, are capable of ex ante specification, the more likely it is that the parties will include the promise in a written contract and opt for legal enforcement.[64] If not, parties have two options: either bond the promise by way of a non-legal sanction or, alternatively, abandon the promise altogether.[65]

Charny's analysis of the role of non-legal sanctions raises vexing problems for Coffee's claim that takeovers invite special treatment for stakeholders because of opportunistic breaching of implicit contracts. Assuming that stakeholders are capable of negotiating rationally with the corporation at the time of their initial contract (or even subsequently upon modification), what grounds are there for legal enforcement of implicit contractual undertakings? In order to have enticed the corporation's stakeholders to agree to perform some service in exchange for an implicit contractual undertaking, a credible performance bond would have to be posted. If, at a later stage, the corporation's shareholders decide to forgo that bond and suffer whatever non-legal sanction is specified, then the stakeholder should not be able to invoke the judicial process to seek redress. Quite simply, the stakeholder's contract was only for performance conditioned upon a non-legal sanction, and, to the extent that a takeover causes shareholders to suffer these sanctions, then there is little in the parties' actual ex ante expectations that supports intervention. In these terms, a shareholder decision to sever stakeholder

62 Williamson 'Credible Commitments: Using Hostages to Support Exchange' (1983) 73 *Am. Econ. Rev.* 519.

63 Charny, supra note 60, 375

64 For a similar argument see Alan Schwartz 'Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies' (1992) 21 *J. Leg. Studies* 271. Schwartz argues that contracts are mainly incomplete due to asymmetric information problems. If certain types of information are observable and verifiable only by the parties, then the parties will refrain from conditioning their conduct on this information and will instead rely on non-legal sanctions.

65 Assuming equality of bargaining power, the calculus governing reliance on legal or non-legal sanctions is unchanged by allowing for mid-stream contractual re-negotiation.

ties to the corporation, and suffer whatever non-legal sanctions were constructed, can hardly be deemed opportunistic. Rather, as in the case of any other right protected by a liability rule, shareholders have simply decided to exercise their right to breach the implicit contract by paying the specified price.[66]

This claim supports even a broader point, namely how few and far between will be those situations in which shareholders will have both the *desire* and the *ability* to deliberately breach implicit contracts with stakeholders in order to expropriate their wealth. In most cases, implicit contracts between shareholders and stakeholders are based on protection of firm specific investment. Assuming that the fruits (rental stream) of this investment are shared equally between both shareholders and stakeholders, any effort by shareholders to sever implicit contracts by, for example, prematurely terminating employee or supplier arrangements will inflict losses on both shareholders and stakeholders. And although shareholders may be in any better position to diversify against these losses, no losses are still better than diversified losses.[67]

One plausible response to this line of argument is based on the unanticipated effect that takeovers can have on non-legal sanctions. Shleifer and Summers, for instance, argue that because takeovers often entail ouster of target management, they will be unable to protect stakeholders from certain harms.[68] Absent takeovers, managers would ensure that no harm would come to stakeholders because they fear consequential debasement of their reputational capital – which, in the managerial market, means a lower level of remuneration. So valuable are managerial reputational bonds in facilitating cost-effective implicit contracting that 'shareholders ... [will] *seek out* or *train* individuals who are capable of commitment to stakeholders, *elevate* them to management, and *entrench* them.'[69]

66 G. Calabresi and A.D. Melamed 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral' (1972) 85 *Harv. LR* 1089

67 One exception to this rule relates to employees or suppliers who were receiving deferred compensation from the firm at the time of the breach of the implicit contract. In this situation, opportunistic reneging by shareholders is costless to the firm because at this point the marginal product of the employee or supplier is less than their compensation from the firm. However, to the extent that job losses or supplier terminations occur on a takeover event, it is unlikely that shareholders will be able to systematically inflict these costs on those stakeholders receiving deferred compensation. This is especially so in unionized workplaces given the protections afforded by seniority.

68 Shleifer and Summers, supra note 8

69 Ibid. 40

Yet, even assuming that shareholders are willing to breach stakeholder implicit contracts, it is not at all clear that managerial reputation is the only, or even the most potent, non-legal bond standing between shareholders and breach. If information markets are effective, and if the corporation has other implicit contracts outstanding, the breach of an implicit contract with one stakeholder class may impact on the value of these other stakeholder contracts because of the adverse reputational signal emitted by the breach. For instance, if an opportunistic breach of an implicit contract with employees is detected and understood as such by the corporation's other present or future implicit contract holders, then shareholder reputation will be depreciated and the overall value of the firm's organizational capital reduced.[70] Consequently, so long as shareholders attach value to the maintenance of existing implicit contracts or on the ability to sell implicit contracts at a later date, the deliberate breach of a stakeholder contract – even in the setting of a control shift – is unlikely.[71]

One possible, though circumscribed, qualification to this claim relates to the possibility that, because of the fundamental re-orientation of a company that follows in the wake of a control transaction, the ability of present and future stakeholders to detect opportunistic breaches will be dulled. In other words, if present shareholders can persuade the firm's stakeholders that it was the old shareholders who had instigated opportunistic breaches of certain implicit contracts, then they may be able to confound the signalling effect of the breach for the firm's remaining stakeholders, thus preserving the capitalized value of the firm's implicit contracts. Alternatively, if the firm's shareholders can credibly convince certain stakeholder groups, say customers, that the breach of an implicit contract with employee groups was idiosyncratic, and does not contain any information about the likelihood of the corporation's respecting

70 Support for this claim is furnished by the work of Cornell and Shapiro. They recount IBM's willingness to manufacture parts and do repairs for its discontinued PC Jr computer line, despite the losses it created for the company. IBM's willingness to honour its implicit contract of parts and service was not motivated by altruism, but by the signalling effect that breach of *this* implicit contract would have on the value of the *other* present and future implicit contracts that the company had sold or may wish to sell at a later date. Bradford Cornell and Alan C. Shapiro 'Corporate Stakeholders and Corporate Finance' (Spring 1987) *Fin. Management* 5 at 8

71 And even if a takeover entrepreneur, who lacks a significant reputational investment, is responsible for opportunistic behaviour, it is still possible that the market will penalize those actors, both sellers and buyers, who transact with him. If these actors are worried about their reputation, they may be constrained from benefiting from, or at least sharing in, the entrepreneur's opportunism.

customer implicit contracts, then the reputational damage may be contained. However, both of these qualifications are predicated on the success of the firm's shareholders in lulling remaining stakeholders into an ill-founded belief that the firm's promises retain their value despite clear evidence to the contrary.

CONCLUSION

In the previous discussion, I identified the defects in the claims of both non-protectionist and protectionists. In essence, the non-protectionist argument failed for its unwillingness to take seriously the presence of conventional contracting failures, while the protectionist position failed for its reluctance to consider either the actual expectations of the contracting parties, or the efficiency consequences of across the board protection. Against this backdrop, I then considered in detail the implicit contractual claim in favour of distinctive treatment for stakeholders following a takeover transaction. Close inspection of this argument, however, revealed several serious infirmities. Of these, the most important relate to the implausibility of special promises for stakeholder protection following a takeover event and the difficulties in knowing whether these promises, even if they exist, are meant to be enforced by legal as opposed to non-legal sanctions. Close evaluation of these arguments suggests that the specific properties of takeover transactions do not appear to support distinctive treatment for stakeholders.

III *Implicit and hypothetical contracts*

In attempting to discern whether or not a stakeholder group is able to extract protection against whatever losses they suffered upon the occurrence of a takeover event, the task of the neutral adjudicator is one of interpretation: that is, what were the understandings and expectations of *these* particular parties as manifested by their written agreement and actual conduct? Of course, divining the precise content of these understandings is an exercise fraught with considerable complexity. Here it is necessary to have regard to the character of the relationship that has developed between each stakeholder class and the corporation. Obviously, the more that a stakeholder relationship veers away from reliance on discrete, presentiated contracts, the more plausible a claim in favour of the existence of implicit contractual understandings. Further buttressing this claim is evidence of concentrated (that is, non-diversified) stakeholder investments in firm-specific capital or of stakeholder reliance on deferred compensation arrangements. But, in undertaking this analysis, it is important to bear in mind the various caveats about the scope and exist-

ence of implicit contracts discussed in the last section. Though not insurmountable, stakeholders must discharge a heavy burden in demonstrating the existence of these implicit contractual understandings, and the consequences that flow from them. Particularly in the light of the self-enforcing nature of most implicit contractual undertakings via non-legal sanctions, it is unlikely that these obligations are able to undergird substantial relief for stakeholders in the takeover setting.

However, if, after the conclusion of this interpretive exercise, it is determined that stakeholder losses are not subject to implicit or explicit contractual protections, does it follow that stakeholders must shoulder the full losses entailed by a takeover event? Under modern contract law theory, the fact that the parties did not turn their minds to a disputed risk in their contractual negotiations may, depending on the underlying nature of the risk, support relief for the parties based on doctrines of mutual mistake or frustration. In this vein, Scott has argued that it is only certain types of risks (exogenous or remote risks that lie beyond the cost-effective control of the parties) that ground relief from promises.[72] In contrast, those risks that are endogenous to the parties, are less likely to invite relief as the parties themselves should have been able to allocate the risks at the time of contract.

Although the conclusion that a risk was not allocated between the parties seems straightforward, a decision to relieve a party from performance on grounds of mutual mistake or frustration focuses on what the parties would have done had they been apprised of the risk at the time of formation (gap filling via hypothetical contracting). It is, of course, apparent that whereas the interpretive enterprise is informed by the actual expectations of the parties, the gap-filling exercise is not – that is, the parties never formed any expectations. Consequently, whoever is charged with adjudicating a dispute over such remote risks is, barring any institutional limitations, free to invoke a fairly broad-based instrumental calculus that will take into account the effects of a certain rule not just on the parties before it, but, as well, on other similarly situated parties.

In the context of stakeholders and takeovers, it is arguable that the parties, rather than having negotiated an explicit or implicit allocation of risk, never turned their attention to the issue of dislocation from a takeover transaction. This interpretation is plausible in the light of the dramatic and relatively recent impact that globalization has had on

72 R. Scott 'A Relational Theory of Default Rules for Commercial Contracts' (1990) 19 *J. Leg. Studies* 597

domestic product, capital, and labour markets. It is, of course, these pressures that are the substantial motivating forces behind the takeover wave, as well as the recent swell in restructuring and rationalization activity among the Fortune 500 companies.

In the following analysis, I consider what the likely configuration of both implicit and hypothetical contracts between each stakeholder group and the corporation is likely to be regarding the rise of the unforeseen risks of a takeover transaction.[73] In doing so, I focus on two stakeholder groups: creditors and employees.[74] I readily acknowledge the malleability of the hypothetical contracting exercise, particularly its capacity to support a wide range of outcomes depending on the assumptions the interpreting party uses regarding relevant expectations (the actual parties, or some broader group of similarly situated parties) and the quality and nature of the environment in which the parties bargained (full or only imperfect information, degree of rationality of parties).[75] The choice of the assumptions that are incorporated into the hypothetical bargaining exercise is related, of course, to preferences over broader normative values.[76] Once, however, scope is allowed for the inclusion of values that are external to the parties' own, the analysis quickly devolves into a straightforward general welfare analysis. And, if broader welfare considerations are used to inform questions of responsibility, there is no inherent reason that responsibility for contractual failure, particularly when it does not derive from strategic behaviour of one of the parties, must be resolved by an ex post transfer of wealth from one contracting party to the other. It may be appropriate for society, rather than either of the contracting parties, to bear the responsibility for assisting the victims of contractual failure.[77]

73 My reliance on a hypothetical as opposed to an actual implicit contract resembles somewhat the analysis invoked by Charny (supra note 60) to determine grounds for intervening in implicit contracts. However, his grounds for intervention are considerably broader than the exogenous risk rationale I propose. Charny would allow intervention whenever parties rely on non-legal sanctions mistakenly, or when it is infeasible for rational parties to draft enforceable terms, or when the law can improve the transactors' welfare through a policy of intervention.

74 In extreme situations, these groups illustrate the weakest and strongest cases for stakeholder protection, respectively.

75 For a lucid analysis see David Charny 'Hypothetical Bargains: The Normative Structure of Contract Interpretation' (1991) 89 *Mich. LR* 1815. Charny refers to these two groups of factors as generalization and idealization, respectively (at 1820–1).

76 R. Craswell 'Contract Law, Default Rules and the Philosophy of Promising' (1989) 88 *Mich. LR* 489

77 This point is elegantly made in Trebilcock, supra note 30.

Therefore, to provide some discipline to this inquiry, the hypothetical contracting framework I use takes into consideration the actual risk preferences of each stakeholder class, as well as their risk-bearing capacity.[78] This framework does not, however, correct for the possibility that some cognitive defect[79] or perverse preference[80] of the parties may distort optimal arrangements. As a basis for intervening in the contracts of stakeholders and the corporation, both cognitive defects and perverse preference problems are clearly at odds with some of the core tenets of normative contractarianism, particularly the premium that it attaches to enabling private parties to order their affairs in the way(s) that brings each of them the greatest utility. If consent based on full information and voluntariness is not sufficient to trigger contractual obligation, then the certainty and integrity of the private ordering regime will be under-

78 In this respect, the analysis is very much in the spirit of R. Posner and A. Rosenfeld 'Impossibility and Related Doctrines in Contract Law: An Economic Analysis' (1977) 6 *J. Leg. Studies* 83, and contrasts sharply with the sharing rule for unforeseen events proposed by Charles Fried *Contracts as Promise* (Cambridge: Harvard University Press 1981) at 60–1.

79 In the stakeholder debate, the most commonly asserted cognitive defect relates to the excessive discounting of future events because of the decision-maker's lack of personal familiarity with a low-probability event such as the possibility of loss following a merger or acquisition. This is the so-called availability heuristic. For a full discussion see Tversky and Kahneman 'Judgment Under Uncertainty: Heuristics and Biases' in D. Kahneman, P. Slovic, and A. Tversky *Judgment under Uncertainty: Heuristics and Biases* (1987).

80 Perverse preference problems relate not to any inherent cognitive limitation of one of the contracting parties, but to the nature of the preferences that inform one or both of the parties' contracting conduct. For instance, because of risk perversion, a stakeholder who had a full ex ante appreciation of both the nature and probability of a loss from a takeover may decide to assume the risk of the event in return for some level of compensation. If the assumed risk crystallizes later, it could, under this rationale, be argued that the stakeholder should be relieved of suffering this loss because of her earlier 'gambling' behaviour. (On gambling and contracts, see: R. Unger 'The Critical Legal Studies Movement' (1983) 96 *Harv. LR* 563.)

Alternatively, being only marginally more consistent with the normative contractarian model, one could argue that even though the stakeholder agreed to assume the risk, she really did not want to, but lacked the self-discipline necessary to resist the lure of ex ante compensation. Sunstein describes this phenomenon as a problem of second-order preferences; that is, when individuals have preferences (unhappiness) about their own preferences. (These problems are discussed in C. Sunstein 'Disrupting Voluntary Transactions' in J. Pennock and J. Chapman (eds) *Markets and Justice: Nomos xxxi* (New York: New York University Press 1989.) Recognition of the role of second-order preferences means that governments should limit the choices available to stakeholders so that they will opt to consume more intensely desired goods. For example, a worker who wishes to achieve security of tenure may be unable to resist the temptation to trade off this security for increased current wages, and may, therefore, benefit from government intervention designed to coerce the consumption of increased security of tenure.

mined. Further, fundamental fairness concerns are raised if the corporation is forced to shoulder the costs of stakeholder bargaining idiosyncracies.

CREDITORS

As measured against both implicit and hypothetical contract tests, of all the stakeholder groups, creditors appear to enjoy the weakest grounds for ex post intervention. This conclusion is directly at odds with the thrust of legal scholars who believe that creditors should be protected by law from the harms of a merger or acquisition event.[81]

First, protection for creditors cannot be justified on the grounds of implicit contractual understandings. In contrast to other stakeholders, the relationship of creditors to the corporation is based on extremely detailed and explicit contractual understandings. If creditors are concerned with the risks of a certain event, protection against that event can be stipulated in debt covenants, the breach of which will accelerate the repayment of the loan.[82] Moreover, to the extent that creditors are unable to anticipate fully all future risks, they can construct a diversified portfolio of investments that will limit the losses they sustain on a given transaction. For these reasons, the claim that creditors are, or should be, the beneficiaries of actual implicit contracts concluded with the corporation should be rejected.

Concern over the structure of the bargaining environment in which stakeholder contracts are concluded furnishes no stronger rationale for hypothetical contractual protection. Market pricing forces, assisted by both underwriter monitoring and review and by credit rating agencies, provide little reason for believing that creditors will be made to bear risks that are knowable at the time of contract formation, but without appropriate compensation.[83] This claim is reinforced by the less severe coordination problems that are faced by creditors in generating and analysing information. In comparison, for instance, to shareholders, creditors usually have more concentrated investments in a given instrument, and, therefore, are more likely to be able to overcome free rider

81 D. Harvey 'Bondholders' Rights and the Case for a Fiduciary Duty' (1991) 65 *St John's LR* 1023; M. McDaniel 'Bondholders and Corporate Governance' (1986) 41 *Bus. Lawyer* 413; 'Bondholders and Stockholders' (1988) *J. Corp. Law* 205

82 C. Smith and J. Warner 'On Financial Contracting: An Analysis of Bond Covenants' (1979) 7 *J. Fin. Econ.* 117

83 See generally Beatty and Ritter 'Investment Banking Reputation and the Underpricing of Initial Public Offerings' (1986) 15 *J. Fin. Econ.* 213, 214, 216–22; R. Gilson and R. Kraakman 'The Mechanisms of Market Efficiency' (1984) 70 *Va. LR* 549, 618–21.

and holdout problems. Indeed, the ability of creditors to impound information of changed market conditions is powerfully demonstrated by the event risk protections (conversion privileges, poison puts) that creditors insisted be incorporated into their contracts after the large leveraged buyouts that were consummated in the latter part of the 1980s.[84] This conclusion is reinforced by the wealth, sophistication, and rationality that characterizes most voluntary creditors.

EMPLOYEES

The highly relational character of most corporate–employee relationships, combined with the difficulties in diversifying away the risks of firm-specific human capital investment, renders it likely that at least some classes of employees are the intended beneficiaries of implicit contracts – although it is unclear whether these undertakings were meant to be enforced by legal as opposed to non-legal sanctions.[85] The claim in favour of implicit contracts is strongest for those employees whose relationship to the corporation is not subject to modification through formalized governance processes, and who are receiving or about to receive compensation in excess of their marginal product to the firm. By laying off these employees permanently, shareholders can appropriate the value of the income previously forgone by employees, without suffering any direct loss. However, as discussed previously, opportunistic firing of these employees may, if detected, impose indirect losses on the shareholders through debased reputational capital. It is less plausible, however, that employees having made firm-specific human capital investments, but whose compensation is still below their marginal product to the firm, are subject to implicit contractual protections. After all, ex ante, employees would assume that the depreciated price for their services would, assuming their continuing value to the firm, be sufficient to bond the shareholders' performance.

Even if the scope of implicit contractual protections concluded by the parties is confined to employees in receipt of deferred compensation, however, concerns over defects in the process by which either explicit or implicit contractual understandings were concluded may undergird protection for employee stakeholders. This protection is, of course, based

84 T. Hurst and L. McGuinness 'The Corporation, The Bondholder and Fiduciary Duties' (1991) 10 *J. Law & Commerce* 187 at 199

85 To the extent that suppliers are closely integrated into the operations of upstream consumers and, therefore, wholly dependent on them, their need for protection against the harms from a takeover analytically resembles that of employees and should be subject to the same policy response.

on hypothetical contractual understandings. For unionized employees, defects in the collective bargaining process, particularly in terms of the limited access that unions have to firm-specific information bearing on the likely risks of a major plant closure or restructuring, colours the fairness of the concluded contracts. Since there is no incentive for management to reveal (or even to produce) information to employees that would suggest a higher than expected likelihood of a disruptive transaction, employees may well bargain on the basis of false premises. And, in the light of the sluggishness of labour markets in adjusting to information, and the highly particularized probability distribution of a merger or acquisition occurring for each firm, market benchmarks will play only a marginal role in correcting mistaken assumptions. These problems are exacerbated by the presence of internal union agency problems.[86]

Moreover, even if employees are able to obtain all of the information in management's possession regarding the likelihood of a merger or acquisition transaction, this information may still be less than is necessary to calculate the future likelihood of such a transaction. With inadequate information, labour representatives are hobbled in their capacity to bargain effectively, thereby increasing the likelihood that bargaining outcomes will deviate from arrangements that have had been concluded in a setting of equal bargaining power and full information. Following Knight, it can be argued that the mergers and acquisitions wave of the 1980s was so remote as to be unpredictable and uncertain to employees concluding contracts several decades ago, and therefore was a risk that was not subject to allocation through the bargaining process.[87] This claim

86 Because of the scant likelihood that the preferences in a union will be homogeneous across the entire membership, union representatives will be forced to choose from among competing preferences in the course of negotiating a collective agreement with management (see B. Kaufman and J. Martinez-Vazquez 'The Ross-Dunlop Debate and Union Wage Concessions: A Median Voter Analysis' (1987) 8 *J. of Lab. Res.* 291; P. Cappelli and W. Sterling 'Union Bargaining Decisions and Contract Ramifications: The 1982 and 1984 Auto Agreements' (1988) 41 *Indust. and Lab. Rel. Rev.* 195). This selection process invariably means that the preferences of some workers will weigh more heavily than the preferences of other workers. Typically, this means that union representatives will focus on the preferences of the median voter, as her support (and the support of inframarginal voters) will be necessary to ensure ratification of a collective agreement under a simple majority voting rule (see B. Howard 'The Interpretation of Voting in the Allocation of Economic Resources' (1943) 58 *Q. J. of Econ.* 27). Obviously, the prospects for non-unionized workers to be able to overcome innate collective action problems is much less certain.

87 Events of this kind differ from risky events that, although having a probabilistic character, can be anticipated and allocated in the contracting process. F. Knight *Risk and Uncertainty* (1921)

can be supported by referring to the myriad factors that combined to ignite the restructuring activity of the 1980s, and the difficulties that employees would have in foreseeing any or all of them, and in discerning their implications. These factors include: the secular decline in levels of trade protection, the dramatic increases in capital mobility, the development of a speculative grade investment bond market, significant innovation in the telecommunications industry, and the ascendancy of Japan and the newly industrialized countries in the world economy. And, although mergers and acquisitions are cyclical phenomena, previous consolidation waves were motivated principally by financial diversification objectives, that is, conglomeratization, which posed the least serious threat to stakeholder interests.[88]

By contrast, it is important to acknowledge that not all employees entered into contractual relationships with the corporation several decades ago, when it would have been most difficult to anticipate the coming takeover wave. Many employees may have concluded first-time contracts with the corporation immediately prior to or during the onslaught of the mergers and acquisitions wave, and, consequently, would possess some capacity to anticipate the effect of these events on their future welfare, and to incorporate this information into their bargaining. There is some evidence for the claim that organized employees have been able – at least in the recent past – to anticipate the harmful effects of mergers and acquisitions activity. Anecdotal data from the United States shows that collective agreements between labour and management increasingly include terms that provide benefits to employees in the event of a merger or acquisition.[89]

88 Daniels, supra note 51

89 E. Kassalow 'Concession Bargaining: Towards New Roles for American Unions and Managers' (1988) 127 *Int. Lab. Rev.* Kassalow reports that the merger mania occurring in the United States has exerted a profound effect on union behaviour. Not only have unions bargained for various notice and successorship clauses, but have also played an important role in the restructuring process, even to the point of arranging employee buyouts and identifying white knight acquirors. Although I was unable to identify provisions in Canadian collective agreements that related specifically to mergers and acquisitions, there is evidence that collective agreements have increasingly included provisions that explicitly provide employees with severance benefits and notice upon a permanent layoff. Whereas in 1980, 34.9 per cent and 47.3 per cent of collective agreements negotiated in Canada *did not* include provision for either severance or notice, respectively, by 1989 these percentages dropped to 27.3 per cent and 40.3 per cent (*The Current Industrial Scene in Canada* (1989)). An example of the specific type of contractual commitments extracted by labour from management in response to a plant closure can be observed in the merger of Carling O'Keefe and Molson breweries. Since the merger was expected to entail the loss of 1,400 to 7,000 jobs, the unions negotiated for a series of benefits for displaced employees, including generous severance pay, early retirement

Additional support for the position that stakeholders have been able to bargain for the risks of harm from mergers and acquisitions can be derived from the recent work of Triantis, who has argued that while individuals may have difficulty in envisaging and bargaining for certain specific future risks, they may be more adept at foreseeing general categories of future risk (in this case, risk of increased leverage, layoffs, and so forth) that subsume these more particularized risks, even to the point of attaching rough probabilities to them.[90] The difficulty, however, with assuming that stakeholder bargaining on the basis of generalized as opposed to specific risks has taken place, is that the probability of even the general class of restructuring and rationalization risks has increased so significantly over the past several decades as to render earlier bargaining outcomes deeply suspect.

In sum, evidence respecting the capacity of organized employee stakeholders to foresee the risks of harms resulting from mergers and acquisitions activity is simply too amorphous and conjectural to support robust conclusions. As the time between contract formation and the commencement of mergers and acquisitions activity narrows, the capacity to foresee both the likelihood and effect of the merger wave increases correspondingly. For these groups, a strong presumption in favour of the proposition that mergers and acquisitions activity was foreseeable should be operative. Other employee stakeholders, however, may have had less opportunity to anticipate harms from mergers and acquisitions in particular, and restructuring and rationalization in general, and, therefore, in the absence of explicit or implicit contractual protection, the content of their bargains is rendered problematic. These groups may be deserving of some type of protection from losses occasioned by a

pension benefits for older employees, continuation of health and dental benefits, and career counselling. See Canadian Labour Views Co. Ltd. 'Facts and Trends' reports. Of course, these data, although consistent with the claim that the risks of permanent layoffs have only recently been identified, cannot be construed as dispositive confirmation of that result.

90 G. Triantis 'Contractual Allocations of Unknown Risks: A Critique of the Doctrine of Commercial Impracticability' (1992) 42 *UTLJ* 450. Triantis draws on the work of Fischoff, Slovic, and Lichenstein 'Fault Trees: Sensitivity of Estimated Failure Probabilities to Problem Representation' (1978) 4 *J. Exper. Psych.: Human Perception and Performance* 330, who found that the probability estimates fashioned by individuals who were exposed to complete fault trees as to why a car would not start were similar to the estimates fashioned by individuals who had access only to pruned fault trees. Following Triantis, it can be argued that, although labour may not have been able to foresee specific harms from mergers and acquisitions, it could have anticipated the likelihood of some rationalization and restructuring activity, of which merger and acquisition activity is simply a subset, and extracted appropriate ex ante protections and compensation from the firm.

takeover, though it is not necessarily clear that the corporation should bear the entire responsibility for providing such protection. Finally, it should be emphasized that the analysis developed above with respect to organized employees applies with equal or greater force to unorganized employees, who are even less likely to be able to overcome endemic collective problems in the bargaining process.

CONCLUSION

The strongest rationales for stakeholder protection in the takeover context were based on defects in the ability of stakeholders to anticipate the likelihood of dramatic corporate restructuring and rationalization activity. This argument applied most forcefully for employees, and, by extension, to some supplier groups having a status analagous to employees. On the other hand, most voluntary creditors do not appear on either implicit or hypothetical contract rationales to be deserving of any ex post intervention. Although these groups may have suffered some transitional harm from takeover activity, they are well suited to insure against these risks, and to correct for them in their future contracts with the corporation.

Conclusion

Given the premium on providing assistance to employee and some supplier stakeholders on a takeover event, the question then becomes, what form should that protection take and who should be responsible for providing it? If the responsibility for the loss is lodged in an implicit contractual understanding between the corporation and the stakeholder, then the answer to this question is relatively straightforward: the corporation should be obligated to the stakeholder to the degree contemplated by the agreement. Much more complicated, however, is how to deal with stakeholder losses when the corporation and stakeholders completely failed to contract for the possibility of takeover-related displacement. If, as argued above, welfare-based hypothetical contracts are used to determine responsibility, the connection between loss and corporate responsibility is attenuated, especially in cases where both parties suffered from information failures.

Although it is beyond the scope of this article to detail the precise instrument mix, one can well imagine a hypothetical contractual rationale that is capable of supporting broad relief for those employees sustaining unanticipated losses from a takeover event. And, depending on the comparative advantages of state versus private delivery of this assistance – measured by administrative efficiency, control of employee and company

moral hazard problems, fairness of delivery, and so on – a well-demarcated role for the state in delivering several of these policies could be supported. As I have argued elsewhere, these policies may include, inter alia, plant closure legislation, mandatory successorship rights, and mandatory bargaining,[91] the idea being that state intervention should be aimed at easing the adjustment to takeovers rather than attempting to restrict or, even worse, preventing these events from occurring in the first place. This follows naturally from the fact that, by and large, the empirical evidence provides overwhelming support for the claim that takeovers are Pareto-efficient transactions.

In the takeover case, one important advantage of state intervention is that it can supplement, rather than substitute for, private ordering. That is, the state's programmes could expand, accordion-like, to envelop only those employees who are truly deserving of protection under the mutual mistake model developed above. If the parties have actually contracted, either explicitly or implicitly, for protection, the state would be bound, in the absence of some other compelling rationale for intervention, to defer to these arrangements.

In considering the appropriate ambit of state intervention, it is important to bear in mind one of the central themes of this article: to the extent that stakeholders suffer losses on a takeover event, these losses are of no different kind than the losses suffered following a wide variety of other types of corporate restructuring that are not accompanied by a change of control. Ultimately, the source of many of these dislocations is an exogenous, hence unanticipated, change in the nature and direction of market forces, which cause abrupt and sometimes radical shifts in corporate policy. If this is the case, the logic of creating tailored remedies for 'deserving' stakeholders on a takeover event is suspect. Far more desirable is the adoption of generic adjustment programmes that are aimed at reducing the private costs of adjustment faced by dislocated employees and suppliers. As Trebilcock, Chandler, and Howse have argued in relation to employees in the trade liberalization context, these programmes would not differentiate among stakeholders on the basis of the source of injury – simply the fact of injury would suffice to attract public assistance.[92] This assistance would be forward-looking, and would be aimed at salvaging a displaced worker's human capital by reintegrating her back into the labour force as soon as possible.

91 Daniels, supra note 51, 220–6
92 Trebilcock et al., supra note 44

In an extremely provocative book entitled *Why Americans Hate Politics*, E.J. Dionne Jr traces current political malaise in the United States to the

> false choices posed by liberalism and conservatism [that] make it extremely difficult for the perfectly obvious preferences of the American people to express themselves in our politics. We are encouraging an 'either/or' politics based on ideological preconceptions rather than a 'both/and' politics based on ideas that broadly unite us.[93]

This observation has great cogency when applied to the stakeholder debate. When capacious, fair-minded interpretations of widely shared contractarian values are invoked, it is possible to support the extension of humane and compassionate assistance to deserving victims of economic transitions, without forgoing the wealth-creating benefits that these transitions confer on society at large. The challenge for policy-makers is to move beyond the paralysing terms of the contractarian–communitarian debate that has thus far limited the imaginative use of constructive policy instruments.

93 E.J. Dionne Jr *Why Americans Hate Politics* (New York: Simon and Schuster 1991) 14–5

[Footnotes]

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